

# Progressive Taxation

## Towards fair tax policies

**Deborah Itriago**

**Oxfam Intermón**

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*In order to be able to find enough resources to ensure public services, such as education and health for all, poor countries need to raise more tax, and raise tax in ways that are progressive and fair. Tax policy in developing countries has been heavily influenced by the IMF and national elites. This has had a negative impact in many cases, with a focus on indirect regressive taxation like VAT, and extensive tax incentives for companies. There is an urgent need for poor country governments to achieve an increase in progressive and redistributive taxes.*

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## Executive summary

This report focuses on tax policy in developing countries: who pays tax, what taxes are paid, and how. Tax policy can have a huge impact on inequality and poverty reduction, either positively or negatively, depending on what tax policies a country decides to implement. Taxation is also often at the heart of the social contract between citizens and their government, and progressive taxation is central to creating strong, democratic, and effective states.

As a percentage of GDP, rich countries collect in many cases more than twice as much public revenue (including taxes) as developing countries. In sub-Saharan Africa, the average is 18 per cent of GDP<sup>1</sup> compared to 38 per cent in western European countries. This report will show that a lot can be done to increase the amount of revenue poor countries get from tax, and that this can be done in a way that tackles inequality, making sure the richest bear the biggest burden. In the 52 developing countries analysed in this report, **we found that significantly improving the collection of tax could potentially raise an additional \$269bn dollars.**

Developing countries' tax and regulation policies have often been imposed, or at least strongly recommended, by the International Monetary Fund (IMF) and other international financial institutions (IFIs) as a condition of their financial support. This reduces the capacity of these nations to openly decide between different policy options, as well as their capacity to control and reduce capital flight and tax dodging. Historically, the IMF have consistently favoured economic efficiency and short-term collection goals over other objectives, often promoting taxes that are easiest to collect, with the lowest political costs, and that least affect the interests of companies and the rich. Such tax policies are not necessarily the most suitable for developing countries. However, recent papers from the IMF show promising signs that this approach may be changing and that they may now be ready to take a more progressive stance on taxation policy.

One particularly noticeable feature of tax reforms in the developing world over the last three decades has been the emphasis on indirect taxes, in particular VAT (value added tax) on consumption.

**Taxes on consumption (mainly VAT) have generally become the main source of tax revenue for developing countries and economies in transition.** In Africa and the Asia Pacific region, indirect taxes grew from 4.6 per cent of GDP in 1990 to 5.4 per cent in 2002, while in Latin America and the Caribbean they increased from 4.1 per cent to 8.8 per cent.

For reasons linked to 'economic efficiency', VAT was the preferred choice of international reformers. The assumption was that VAT would create the opportunity to broaden the tax base, reaching all goods in the formal sector without distorting productive processes.

This doctrine has found its way into the loan and aid conditions laid down by the IMF and World Bank in many developing countries. In Pakistan, for example, the World Bank and the IMF linked their budget support to the introduction of VAT, amongst other things. A Eurodad and Action Aid report (quoting a study by Damme et al (2008) of 54 developing country enquiries to the IMF under Article IV Consultations) found that VAT was recommended or approved by the IMF in 90 per cent of the total sample of IMF reports analysed.

One clear part of this approach was abandoning the previous IMF doctrine that, by making the rich pay more than the poor, tax itself could be used to reduce inequalities. In fact the opposite is often the case. This is because the poor consume more of their income than the rich, who have savings. This makes VAT and other consumption taxes often regressive, hitting the poorest hardest.

Instead the IMF promoted VAT and other consumption taxes, believing that wealth redistribution would occur mainly through public spending, paid for by tax revenue. This stands in contrast to all developed nations, where tax collection plays a direct and key role in tackling inequality by ensuring the richest sections of society pay more tax than the poorest.

There has been an attempt in many countries to exempt some basic goods from VAT that are used mainly by the poor, such as soap or food. Often VAT exemptions have also been made on agricultural products where the rural sector is often very important.

Nevertheless, the general impact of implementing consumption taxes on inequality and the redistribution of wealth, was not carefully analysed in all cases, and nor was the negative effect on the poorest sectors fully anticipated. For example, the above quoted study stated that VAT was recommended or approved by the IMF in 90 per cent of cases and 80 per cent of the consultations recommended a reduction in tax exemptions. However, the distributional impact of abolishing the exemptions was analysed in only 25 per cent of cases.

In addition to the promotion of VAT, during the 1990s and 2000s, the IMF, World Trade Organisation (WTO), and World Bank promoted trade liberalisation through removing tariff and non-tariff barriers, as well as a wide generalisation of customs unions, free trade areas, and free trade agreements. This caused taxes on international trade (exports and imports) to be drastically reduced. Before these reforms, trade-related taxes represented a significant proportion of tax revenues for many poor countries, and research suggests that most low-income countries have only recovered a fraction of these losses. Only in a very few cases have they been fully recovered.

This reduction in trade-related revenue was followed by the 2008 economic crisis. According to Oxfam's research, the economic crisis has left a \$64.4bn dollar hole in the budgets of the poorest countries,<sup>2</sup> and is now leading to many rich countries cutting their aid flows.

Another issue stemming from the international context which affects the finances of developing countries is capital flight, tax avoidance, and evasion. One respected source asserts that even by conservative estimates, the illicit financial flow of potentially taxable resources out of developing countries in 2008 was between \$1.26 and \$1.44trn.<sup>3</sup> Approximately half of these resources from 2002 to 2008 were diverted through trade mispricing practised by multinational companies, the other remaining flows being due to corruption and criminal activities.

Tax havens clearly encourage tax dodging and have become a black hole in international finance allowing individuals and companies to escape from some of the financial and legal regulations in their home country. In the aftermath of the 2008 financial crisis, the Organisation for Economic Co-operation and Development's attempts at tackling this problem have proven largely ineffective: in order not to appear on their 'blacklist' of uncooperative jurisdictions, tax havens were required to sign 12 Tax Information Exchange Agreements with other jurisdictions. In practice, this meant that one tax haven only needed to sign an agreement with 12 other tax havens to get itself off the blacklist. There were no enforcement mechanisms. This initiative has since been superseded by a highly political and time consuming peer review exercise with 100 countries, which is due to last at least until 2014. Furthermore its model of tax cooperation, based on bilateral agreements with the burden of the proof being on requesting countries, raises several serious concerns about whether developing countries will be able to recover any lost taxes from tax havens even in the medium term.

This research report will also highlight the proliferation of unfair corporate practices. The vast majority of multinational groups only provide consolidated global financial information with no basic details on their activities in the country where they operate. In

2010, the Global Financial Integrity think tank made a conservative estimate that developing countries' annual tax revenue losses attributed to corporate trade mispricing practices (between related or unrelated parties) were likely to have amounted to \$98–106bn between 2002 and 2006, roughly the amount of ODA at that time.<sup>4</sup> At the same time, corporate business models are turning into complex structures involving hundreds of subsidiaries, intentionally designed to reduce their tax bill at the global level. This opens a broad space for corporate abuses through intra-group transactions to artificially reduce company profits and shift profits to tax havens. The lack of transparency in consolidated accounts prevents an accurate calculation of the revenue accrued by a company in a given country and makes any real attempt to monitor transfer mispricing a farce.

## **Reduction in taxes on businesses and incomes, and an increase in tax breaks**

A global trend, not limited to developing countries, has been the **decline in taxes levied on business activity**. One of the differences between rich and poor countries is that in the former the reduction in such taxes has not resulted in a reduction in tax revenue overall. In developing countries, however, tax revenue has fallen. According to some estimates, between 1990 and 2001 the reduction in corporate taxes accounted for a drop of nearly 20 per cent in these countries' tax revenue.

**Revenue from personal income taxes still accounts for less than 2 per cent of GDP in low-income countries, whereas in high income countries it accounts for about 7% of GDP.** This is partly because income tax is often difficult to manage and partly because the structure of the system tends to reflect political commitments, such as generous exemptions and deductions for those with the highest income.

In Latin America, in particular, personal income tax is not generally applied to the income and returns from capital, which are heavily concentrated in the high-income brackets. In some countries in the region, attempts to increase taxes on wealthier groups have met with fierce resistance, resulting in dramatically watered down tax reforms. The threat that such reforms will drive money away and into tax havens has been problematic.

The term 'tax expenditure' refers to the exemptions, credits, deductions, deferrals and refunds that some taxpayers can benefit from and which are a cost to the state. In general, **tax expenditure is the result of any kind of preferential and differential treatment that deviates from the basic tax system and benefits a specific sector, branch, region or group of taxpayers.** Estimates of tax expenditure vary from 2 to 8 per cent of GDP for those countries from which data was collected. In 2008, Nicaragua exempted the equivalent of \$415.6m while in India and Bangladesh the tax expenditure in 2005 was equivalent to 51 per cent and 31 per cent of their total tax revenues respectively. Poor countries lose out through tax expenditure, which benefits certain sectors and groups of taxpayers, but cuts the overall amount of public revenue.

### **Bringing the informal economy into the tax system**

In the majority of developing countries the informal sector of the economy is huge, much larger than in developed countries. Some research estimates that the losses from not taxing the **informal sector** could amount to between 35–55 per cent of tax revenues collected in some developing countries. The challenge is to determine whether a legitimate motivation – such as increasing tax revenue in developing countries – may lead to policies that exacerbate poverty and increase the vulnerability of certain sections of the population. This is because often those working in the informal sector are some of the poorest, for example women who run small businesses selling vegetables or other goods.

It is therefore crucial to distinguish between different types of informal sector actors in order to achieve a political solution that is just and consistent with the fight against poverty and inequality. Gradual formalisation of the economy must be the aim and is positive in the long-term. However, measures taken to tax the more vulnerable, informal economy or enforce regulations are often arbitrary and fail to deal fairly with conflicting interests.

**Domestic institutional weaknesses** are chiefly due to tax administrations' lack of capacity. Poor co-ordination between different offices makes it difficult to properly penalise non-compliance. Institutional weakness promotes abuse and corruption in both the public and private sectors. It is also exacerbated by lax international regulations which tend to favour multinational companies. As a result, poorly-equipped tax administrations lose revenues and the people who do pay tax also lose out. Related to this, taxation at the sub-national, local level is often inefficient and unfair. Although national tax systems generate the bulk of tax revenues in developing countries, local tax systems exert a significant impact on ordinary citizens.

Some experiences, though far from perfect, illustrate specific attempts to build fairer fiscal systems in developing countries and begin to show us a way forward. Malaysia, for example, has implemented comprehensive measures to tackle inequalities affecting the country's ethnic groups. In Ghana, a relatively successful pioneering attempt was made to create forms of taxation best suited to the informal sector, involving trades unions and aiming at a progressive formalisation of the informal economy.

## Increasing tax collection: what needs to happen

In the final chapter this report estimates the **potential income** that could be generated if the tax policies of a series of developing countries were improved. **Improvements could be achieved by formalising part of the informal economy, reducing tax dodging currently occurring through the use of tax havens, reducing tax exemptions, and raising direct taxes, especially taxes on non-wage incomes.**

- Firstly, we estimate how much more tax could be collected by addressing **the informal and underground economy**, incorporating part of it into the formal economy. This scenario could generate additional revenues of **\$101bn** per year in the more ambitious option and **\$50.5bn** in the moderate scenario, in the selected 52 countries analysed.
- Secondly, we estimate a possible improvement in tax collection by **raising the tax to GDP ratio**. With the proposed improvements in tax collection in the countries analysed, a revenue increase of up to **\$269bn** would be obtained with the more ambitious option and **\$134bn** in the more cautious option.

Using United Nations calculations, the required financing to meet the Millennium Development Goals (MDGs) (from both internal and external sources) was approximately **\$454bn** in 2010. **This sum could be covered by up to 60 per cent through the more ambitious option - and by almost 30 per cent by adopting the more moderate option.**

## Conclusion

There is a clear need for fairer and increased taxation in developing countries. The evidence confirms that a failure to find ways of taxing more, and more fairly, seriously constrain the ability of developing countries to fulfil poverty reduction and equity objectives, as well as their ability to build stronger and more accountable states.

One of the main conclusions of this research report is that governments in developing countries have not made the most of tax policies as a tool for achieving poverty

reductions; policies promoted by IFIs have instead opposed positive reforms to deal with inequality, while the interests of international private investors in low taxation have not helped. Some of the factors behind the 'failed tax policy' in developing countries that can and should be reversed include:

1. **Overall tax revenues falling short** of those that theoretically could be obtained when countries' productive potential is analysed.
2. The **imbalance between direct and indirect taxes in total revenue collection and the very little tax revenue obtained from taxing businesses and the owners of capital**. Instead taxation has focused on levying taxes on consumption which is potentially regressive.
3. **Tax breaks** chiefly benefiting rich people and the profits of national and international companies. There is little evidence to indicate that these exemptions are attracting the kind of added-value investments that would have a positive impact on development.
4. **Tax dodging by medium and large companies in the informal economy**, contributing to a systematic violation of the rights of poor, vulnerable workers. Meanwhile, **some measures taken to tax the more vulnerable sectors of the informal economy are often arbitrary and undermine poverty reduction efforts**.

Although we cannot ignore the responsibility of developing countries themselves for this situation, the international context and international actors also bear a significant responsibility.

5. **IFI demands and conditions, which favour economic efficiency and short-term collection goals over any other objectives, have resulted in the promotion of taxes with less political costs, affecting company interests and the rich sectors of the population as little as possible**. These taxes are easier to collect but are not necessarily the most appropriate for the circumstances in developing countries. **Their likely impact on the redistribution of wealth or their negative impact on the poorest sections of the population was not analysed carefully enough before they were introduced**.
6. **Secrecy jurisdictions, more commonly known as tax havens, have been a barrier to increasing taxation** of the population's richest sectors and of companies that operate in developing countries.
7. **There has been a proliferation of unjust corporate practices, such as the altering of intra-group trading prices** by multinationals and the opacity of company accounts. This makes a farce of any real attempt to monitor the financial resources that are expropriated from developing countries.

ODA policies have so far played a limited role in promoting fairer tax systems, even though there is a clear opportunity for donors to support governments in constructing such systems and making tax collection more efficient and effective. Donors could also play a role in backing reforms and policies that would create greater transparency in the handling of public finances at all levels of government.

This report shows clearly that a lot can be done to increase the amount of revenue poor countries get from tax, and do this in a way that tackles inequality, making sure the richest individuals and large corporations bear the biggest burden. The current situation is unsustainable and untenable.

# 1. Introduction

From Monterrey in 2002 to Doha in 2008, the financing for development agenda has highlighted the need to complement the financial resources of international aid with domestic resources mobilised through economic activity undertaken in developing countries themselves. Domestic resource mobilisation fulfils two key objectives sought by developing countries: predictable and sustainable financing on the one hand and a reduction in long-term dependence on aid on the other. Tax resources allow a state to finance itself without resorting to printing money or foreign indebtedness. They, therefore, hold the key to economic stability; enabling investment in infrastructure, proactive social policies, and the accumulation of savings. These savings can then be used to build the resilience of the most vulnerable sections of the population in times of recession.

A comprehensive fiscal policy encompasses the concepts of tax policy and public expenditure policy. It requires a strong tax administration and a specific regulatory and disciplinary framework. Such a fiscal policy is fundamental to the fulfilment of a government's responsibilities in the fight against poverty. It is also essential for the achievement of a fairer distribution of a nation's wealth. In fact, it is one of the primary tools available to governments to reduce the socio-economic inequality that ultimately affects growth and overall productivity and is a hazard to both rich and poor.

For developing countries, making the most of **the potential of domestic resources as a source of funding for development** remains a paradoxically complex task. A subset of external and internal constraints has limited greater use of key resources in the fight against poverty and inequality.

**The average tax to GDP ratio in developing countries is low compared to the majority of countries with the most developed economies, but more importantly it is low compared to its own potential.** In the period 2006–08, central government tax revenue as a percentage of GDP in western European countries was approximately 20 per cent, while in regions such as South Asia it was equivalent to 12 per cent.<sup>5</sup> If one includes the tax revenues of sub-national governments and contributions to social security funds, the tax to GDP ratio in western European countries averaged 38 per cent in 2008, with countries such as Denmark, Sweden, and Norway boasting tax ratios of 48.2 per cent, 46.3 per cent and 44.2 per cent respectively.<sup>6</sup>

Even if one includes the additional sources mentioned above, the average tax to GDP ratio in Latin America in 2008 did not exceed 20 per cent. In that region, tax revenues from central government in relation to GDP have remained at around 15 per cent in recent years.<sup>7</sup>

What is notable about the low average tax ratio in developing countries is that it has persisted, in spite of the many reforms undertaken since the 1990s. In sub-Saharan Africa, according to the International Monetary Fund (IMF), the percentage of tax revenue to GDP increased from less than 15 per cent in 1980 to a little over 18 per cent in 2005. However, this rise was due almost exclusively to the increase in revenues stemming from natural resources, such as operating permits, corporate taxes, and taxes on the production and export of mineral and petroleum resources. **The collection of other taxes rose by less than 1 per cent of GDP over the course of 25 years and regular budgets are increasingly financed by aid.**<sup>8</sup> For example, from 1997–99 to 2004–06, the share of current spending financed by aid increased from 16 per cent to 36 per cent in Ghana, from 22 per cent to 40 per cent in Tanzania, and from 60 per cent to 70 per cent in Uganda.<sup>9</sup>

## Tax reform: a key to combating inequality

Putting aside for a moment the international responsibility for the challenges facing developing countries, the following questions bear consideration:

- **Can societies become more egalitarian or better able to meet the needs of the poorest without thorough reform of the foundation and focus of their tax policies?**
- **Can such policies be achieved without a deeper analysis and understanding of the realities of life for the population living in extreme poverty and vulnerability?**
- **Are taxation models that ignore the increasing size of the informal and underground economy (and the lack of formal representation of those who operate in this economy) socially and economically sustainable?<sup>10</sup>**
- **Is it possible to combat poverty and inequality without the institutional reinforcement of tax administrations, sanctioning bodies, and regional governments?**

It is clear that economic and political elites in developing countries need to show more commitment to accepting and promoting policies of greater social inclusion. Even if there is movement against tax havens at the international level and multinational companies refrain from transfer pricing abuse, these actions will be insufficient without a profound revision of domestic tax policies in a pro-poor direction. No resources should be spared in order to significantly improve developing countries' public administration capacity so that they can meet their obligations to the most disadvantaged. Without internal policy changes, developing countries will be unable to exploit the full potential that a good domestic fiscal system could provide in the fight against poverty and inequality. Nor will they be able to build solid and efficient states that can generate and administer both their own resources and those derived from international co-operation. It is during periods of crisis that policy-makers are often prompted to recognise that taxation is a reliable source of funding. But a fair taxation system warrants further assessment for more fundamental reasons. As well as generating new revenue, a comprehensive tax policy can provide the structural basis for the building and consolidation of genuinely democratic states. Fiscal systems should be based on a regularly-renewed agreement or contract between governments and citizens. Such a contract – in the form of democratic elections – should result in increased government responsibility for the use of tax revenues.

Despite the importance of taxation to development, bilateral donors have paid little attention to it. In 2008, only one per cent of bilateral Official Development Assistance (ODA) was allocated to the improvement of public finances, according to our calculations and based on data taken from the Organisation for Economic Co-operation and Development's (OECD) Development Assistance Committee.<sup>11</sup>

**Oxfam recognises that a high-quality aid system should pave the way for independence from aid itself**, as explained in its 2010 '21<sup>st</sup> Century Aid' report (Oxfam 2010). High-quality international co-operation can collaborate with and complement the economic and technical efforts of developing countries in the task of building fair tax systems. There is some evidence that this is possible, but better and more consistent actions must reinforce this belief.

## Report structure

**This report will focus on tax collecting strategies in developing countries. It will also analyse the strengths and limitations of such strategies in the fight against poverty and inequality, with reference to specific examples.** Although the international financial crisis has adversely affected the finances of developing countries, there is evidence that solid and consistent domestic reforms could make taxation an effective tool for the fulfilment of the MDGs.

Chapter 2 will focus on the conceptual aspects that define a tax system. Chapter 3 explains the need for a more favourable international framework for developing countries and examines the assumptions made by the IMF to date. Chapter 4 addresses the domestic barriers that developing countries have to overcome when they try to use tax policies as an instrument in the fight against poverty and inequality. Chapter 5 draws out the policy implications of such barriers. Chapter 6 describes some positive experiences in the achievement of fairer fiscal systems and finally Chapter 7 estimates the potential domestic resources that could be generated if tax policies in various countries were improved.

## 2. The design of a fair tax system

**A fiscal system is a combination of tax and public spending policies within an administrative and legal framework. Each of these elements influences how well a fiscal system may perform in the fight against poverty and inequality.**

Fiscal policy consists of a tax strategy or policy (a system for revenue to be collected in the form of taxes) and a public spending strategy or policy, which complement each other. Guaranteeing their proper functioning is vital for developing countries. Although **this report focuses solely on analysing the tax dimension** of fiscal policy, we must emphasise that without good spending policies, a good tax policy has very limited potential for achieving redistribution.

There are two main purposes of taxation:

### a. Fiscal

Money is collected to satisfy a public need, i.e. to finance different public services.

### b. Non-fiscal

Tax is levied on certain economic sectors, thus influencing their functioning in order to directly serve a public need or interest. A classic example is taxation of tobacco and alcohol. Such taxes are intended to regulate the behaviour of development agents, stimulating good habits and practices and discouraging bad ones. In order to inhibit the production and consumption of products (or activities) that have been deemed detrimental, they are taxed at a higher rate than other products or activities.

## Tax policy

A tax policy or strategy involves the identification of levels and methods of taxation. Here, it is worth distinguishing between taxes and charges. In many countries, the payment of certain charges is linked to the provision of specific public services, such as a charge for garbage collection or a charge for public education. As a general rule, these charges are not obligatory except when a citizen wishes to use certain public services.<sup>12</sup>

### *Who pays*

**A key element in any tax policy is the definition of who is ultimately responsible for paying the state for income perceived and/or productive activities carried out.** People can be taxed as individuals, businesses, or organisations. A tax policy also has to identify who will be exempt from paying the tax, in order to achieve a variety of social, economic, and, above all, political objectives.

### *What must be paid*

**A tax policy also identifies where taxes are applied,** such as income or profits, wealth, consumption, production, internal transactions, or international trade, among others. Direct taxes are those applied to a direct manifestation of economic capacity, such as possession of wealth or receipt of income. Indirect taxes are applied to indirect manifestations of economic capacity, such as consumption.

In most tax systems the most common direct taxes are income taxes or taxes levied on the financial income of persons and corporations, as well as those levied on wealth and property, exports, and inheritances or donations. Typical indirect taxes include value-added tax, excise taxes (known in many countries as internal taxes), and import duties.

## How payment is made

The combination of policies that determine who pays what tax – and how – can have significant implications for people living in poverty. Tax policy is seldom neutral – quite the opposite. To understand this, it is important to grasp the concepts of *efficiency* and *equity* (see Box 1) and the features of *progressive* and *regressive* taxation. If a tax system is based on taxing workers (through their wages) more than capital, it is an unjust fiscal system which may impede the fight against poverty and inequality.

### Box 1 The nature of a tax policy

Academic doctrine suggests that a fiscal system should at least fulfil the following objectives:

**Efficiency:** The tax should cause as little interference as possible in economic decisions that would be made if the tax did not exist.

**Equity (horizontal or vertical):** Horizontal equity: equals should be treated the same fiscally (the same income should be taxed the same way, whether it is a result of capital or work). Vertical equity: those that are not equal should be treated differently. The fiscal system should redistribute part of the resources of the wealthier sectors to more disadvantaged sectors.

The principle of taxes being paid according to the taxpayer's ability to pay should be upheld in both situations.

As with the term 'equity', a tax policy is often called *progressive* when it is based on the principle that the greater the earnings or income, the higher the percentage in taxes that must be paid. If the rich pay proportionately more tax than is levied on the income of the poor, the system is *progressive*. If the reverse is true, it is *regressive*.

A tax policy is *efficient* or *inefficient* depending on how far it distorts the decisions that people or businesses make about consumption, savings, and investment. For example, if corporate profits are taxed inappropriately, this may deter companies from investing, because they may believe that the post-tax profit margins would be inadequate.

**Table 1 Taxes and their potential impact on efficiency and equity**

Category // Tax	Basic features <sup>13</sup>	Equity (Progressive or Regressive) <sup>14</sup>	Efficiency <sup>15</sup>	Administrative cost <sup>16</sup>
<b>Value-added tax</b>	<ul style="list-style-type: none"> <li>- Applicable to all market consumers.</li> <li>- Affects consumers' final price, but not production costs.</li> </ul>	Regressive <ul style="list-style-type: none"> <li>- Equal taxing for the spending of rich and poor people.</li> <li>- The poor spend a higher proportion of their income on consumption than the rich.</li> </ul>	Moderately efficient <ul style="list-style-type: none"> <li>- A uniform tax is applied (making no distinction between sectors unless required).</li> <li>- Does not differentiate between imported and local goods.</li> </ul>	<ul style="list-style-type: none"> <li>- Both companies and state require a good accounting system in order to implement it well.</li> <li>- Proportionately more expensive for smaller companies.</li> </ul>
<b>Personal income tax</b>	<ul style="list-style-type: none"> <li>- Taxes all income or profit whether wage-based or not.</li> <li>- The burden cannot be transferred to another agent; it is the responsibility of the individual.</li> </ul>	Progressive <ul style="list-style-type: none"> <li>- Individualised taxing.</li> <li>- People with more money pay proportionately more.</li> </ul>	Not very efficient <ul style="list-style-type: none"> <li>- Reduces people's savings capacity</li> </ul>	<ul style="list-style-type: none"> <li>- The state must have a good system to control taxpayers.</li> <li>- Does not entail a high cost to individuals.</li> </ul>
<b>Corporate tax</b>	<ul style="list-style-type: none"> <li>- Tax on company profits.</li> <li>- Affects the owner of capital or can be transferred to the</li> </ul>	Progressive <ul style="list-style-type: none"> <li>- Payment based on income.</li> <li>- Evidence exists that it is</li> </ul>	Not very efficient <ul style="list-style-type: none"> <li>- Discourages production because it reduces profits.</li> </ul>	<ul style="list-style-type: none"> <li>- Proportionately more expensive for smaller companies.</li> </ul>

	consumer via product price.	regressive for low production levels and progressive thereafter.	- Reduces savings capacity.	
<b>International trade tax</b>	<ul style="list-style-type: none"> <li>- Import and export tariffs.</li> <li>- Charged at customs at the time the transaction is made.</li> </ul>	<p>Possibly progressive</p> <ul style="list-style-type: none"> <li>- Imports: In general the richest import more.</li> <li>- Exports: It depends whether the product is consumed in the country or not, and if it is produced by rich or poor sectors.</li> </ul>	<p>Not very efficient</p> <ul style="list-style-type: none"> <li>- Differentiating between local and foreign production creates market distortions.</li> <li>- Often protects the least efficient, e.g. import duties.</li> <li>- Discourages export sector production.</li> </ul>	<ul style="list-style-type: none"> <li>- Relatively low as it is only paid at customs.</li> </ul>
<b>Excise tax</b>	<ul style="list-style-type: none"> <li>- Only specific goods are taxed.</li> <li>- The tax is principally borne by consumers as the price of these inelastic goods has little effect on demand for them.</li> </ul>	<p>Generally progressive</p> <ul style="list-style-type: none"> <li>- Allows for different rates depending on the product (higher rates are applied to luxury goods and lower rates to those goods with greater demand among the poorest groups).</li> </ul>	<p>Relatively efficient</p> <ul style="list-style-type: none"> <li>- Creates differences between products but only for a few goods.</li> <li>- Taxes may also try to correct market flaws.</li> </ul>	<ul style="list-style-type: none"> <li>- The cost and effort of fiscal control must be offset by significant income from taxing only a few goods.</li> </ul>
<b>Property tax (land, wealth, etc)</b>	<ul style="list-style-type: none"> <li>- A fixed tax for a certain amount of land.</li> <li>- Paid by landowners.</li> <li>- Tax based on the property value.</li> </ul>	<p>Progressive</p> <ul style="list-style-type: none"> <li>- Those who own more land pay more.</li> <li>- Those whose property is more valuable pay more.</li> </ul>	<p>Efficient</p> <ul style="list-style-type: none"> <li>- Does not distort prices because it is a fixed rate per quantity of land.</li> <li>- Acts as an incentive to make the land productive.</li> </ul>	<ul style="list-style-type: none"> <li>- Requires a good system to assess value of property or land.</li> </ul>

Source: Our compilation based on various sources. Gemmell and Morrissey (2003); Stiglitz and Emran (2007); Tanzi and Zee (2000)

## Tax incentives

A factor that has become very significant in the performance analysis of tax systems in developing countries is the gap between nominal or statutory taxes and the real taxes individuals and corporations end up paying, as a result of the proliferation of so-called tax incentives or stimuli. As will be explained in more detail later in this report, this is a common practice in developing countries. However, there is no clear evidence of the net benefit of such measures where they have been implemented.

The most widespread tax incentives used by developing countries to promote investments are tax holidays and 'special development' or free trade zones – precisely the incentives which research shows have potentially damaging effects.

## Tax incentive typology

<p><b>Tax holidays</b></p>	<p>A tax holiday is a temporary reduction or exemption from tax for companies. Tax holidays are used to promote investment based on zero taxation over a period of time.</p> <p>When there is a tax holiday, profits are exempt from tax regardless of their size. There is therefore a risk of favouring investors who expect high returns and who would have made the investment anyway, without the incentive of the tax holiday.</p> <p>Although the duration of a tax holiday is limited by law, it is susceptible to abuse. Companies can creatively redesign their investments so as to continue to enjoy a tax holiday (e.g. by closing a company and reopening the same project with a different name but the same owners).</p> <p>A tax holiday may be an incentive to tax dodging; companies that are not eligible for a tax holiday may engage in financial transactions with exempted companies solely in order to transfer profits from the former to the latter and avoid paying tax on that profit.</p> <p>Companies are not taxed in their first years of existence, a period when typically there are losses in the case of companies looking to make a long-term investment. As such, for these types of companies a tax holiday is not a very efficient incentive. By contrast, if tax holidays with time limitations attract only short-term projects, there will be no tax revenues at all for the developing country where the investment has taken place.<sup>17</sup></p> <p>The obligation to pay taxes is associated with a state's ability to monitor a company. When that obligation is taken away, there is a possibility that a government might lose its ability to monitor the company's activities and with it the ability to know the real total amount of the subsidy made to the company through the tax holiday.</p> <p>According to economic theory, this is one of the most damaging tax incentives.</p>
<p><b>Free trade zones or special development zones</b></p>	<p>A free trade zone is a demarcated territory within a country where the assembly, storage, and distribution of merchandise is allowed with certain tax benefits, such as non-payment of import duties on merchandise or the waiving of certain taxes while the goods remain within this zone.</p> <p>Many national governments establish free trade zones in remote or border regions in order to attract capital and promote economic development in those areas. Large shopping centres are often created and assembly industries or special warehouses for merchandise in transit are often set up there as well.</p> <p>Free trade zones have at first tended to attract investment in labour-intensive sectors, such as the textile industry or the manufacture of toys, clothing, or sport products. Later they appear to attract investment in goods of longer duration, such as auto-parts. The most successful zones have attracted high-technology sectors, such as electronics or precision engines, but these require a supply of qualified workers and seem to be an exception to the rule.</p> <p>Countries with successful free trade or special-development zones have managed to create a connection between the activities carried out within the zone and the development of their economies, especially investing in the skills of the nearby population. Successful examples have been recorded in Ireland, Taiwan, Korea, Malaysia, Singapore, Puerto Rico, and Costa Rica.</p>

<p><b>Tax credits</b></p>	<p>Tax credits are generally viewed more favourably by economists than the tax incentives described above, in spite of some disadvantages.</p> <p>Tax credits function as a set amount that is credited to a selected company. In this way, the company is obliged to operate in a normal way and to declare all of its profits. Once the time for tax payment arrives, the company's taxes are deducted from the credits available to it.</p> <p>The subsidy given to the company can be budgeted for and guaranteed; the state knows exactly how much tax income it has relinquished.</p> <p>However, tax credits require a clear and transparent mechanism for choosing which companies are to benefit.</p>
<p><b>Accelerated depreciation</b></p>	<p>When companies pay taxes on their profits, they are allowed to include the depreciation in value of their capital goods among their deductible expenses. In this way, profits are reduced and consequently the amount of taxes to be paid also falls. In an accelerated depreciation method, depreciation costs for future years can be included in the depreciation of the first years. For example, equipment which fully depreciates in 10 years (that is to say, at 10 per cent per year) can be charged at 20 per cent: the company deducts the depreciation costs during the first five years. This creates a deferral in tax payment.</p> <p>Accelerated depreciation encourages investment by aiding companies when they make a major investment and then encourages them to renew their capital.</p> <p>This is one of the incentives most recommended by economists, though fiscal experts recommend that there should not be more than four goods depreciation categories.</p>
<p><b>Carrying losses forward</b></p>	<p>Carrying losses forward is the method of encouraging investment most favoured by economists specialising in tax incentives.</p> <p>Companies that incur economic losses in year 't' can transfer them as a 'cost' to year 't+1'; consequently revenues for year 't+1' decrease and so do the taxes levied on profits.</p>

Source: Our compilation based on various sources.

### 3. An unfavourable international framework

Identifying where the influence of the international arena starts and ends and the extent to which the creation of fair tax systems is a purely domestic matter for the governments of developing countries is far from easy. What is clear is that certain situations are unlikely to be resolved in favour of the poorest countries unless they are tackled by appropriate international decision-making bodies.

One of the goals of national tax reform is to design tax systems that permit a sustainable increase in the revenues attained from taxation. This usually requires a strengthening of mechanisms to prevent tax dodging and the illicit removal of capital from a country, activities which represent a damaging reduction in already scarce domestic resources.

International context has significantly shaped the fiscal policies adopted by developing countries, in large part imposed by international financial institutions (IFIs). It has also severely reduced the possibilities for these nations to track and reduce the enormous outflow of resources to multiple destinations, as is the case for developed countries.

The situation is already a cause for concern, and there is a danger that things will get worse. The combination of the worldwide economic crisis, unfavourable trade and investment agreements, and cuts in development aid threatens the already precarious public finances of some developing countries.

#### IFIs' influence: tax policy doctrine and conditions

In the past, the conditions imposed by IFIs when awarding loans to developing countries have sometimes had a harmful effect on the model of tax policies adopted (see next section). As Box 2 shows, IFIs, until now, have favoured economic efficiency and short-term collection goals over other objectives. As a result, taxes that are the easiest to collect and with the lowest political costs have been promoted – usually those that least affect the interests of companies and the wealthy. But these are not necessarily the most suitable for developing countries.<sup>18</sup>

Most general academic theory on what makes a good tax system identifies several goals beyond the search for economic efficiency. However, the doctrine promoted by international organisations, such as the IMF, appears to prioritise economic efficiency over any other goals, arguing that a good tax system is one which **limits any distortions that may affect the decisions of economic agents with regard to investments**.

**Based on this view**, the reformists' preferred choice was the value-added tax (VAT). VAT embodies the principle that goods should be taxed uniformly, covering most products and intervening as little as possible in the productive process. Policy makers assumed that this was an opportunity to broaden the tax base, reaching all goods in the formal sector.

VAT would allow the tax to be charged to the end consumer; would not distort the intermediate stages of production (through the zero balance mechanism for VAT paid<sup>19</sup> and VAT charged<sup>20</sup>); would induce companies to keep better accounts; and, when necessary, would allow for the implementation of differential rates.<sup>21</sup> Another factor that made VAT attractive was that it would keep direct taxes lower and create fewer distortions in international trade. The theory was that VAT would maintain revenue collection levels but with little negative impact on international trade.

With such assumptions underpinning their policy, the IMF and World Bank have attached the introduction of VAT as a condition for giving loans or aid in many developing countries. After the floods in Pakistan, the World Bank and the IMF linked their budget support to, among other things, the introduction of VAT.<sup>22</sup> An ActionAid

and Eurodad report (quoting a study by Damme *et al* (2008)<sup>23</sup> of developing countries' enquiries to the IMF under Article IV Consultations), states that,

VAT was recommended or approved by the IMF in 90 per cent of total sample (54 reports) and 80 per cent of the consultations recommended a reduction in tax exemptions (...) However, the distributional impact of abolishing the exemptions was analysed in only 25 per cent of cases...

In 1998, in order to become a beneficiary of the Highly Indebted Poor Country (HIPC) Initiative, Mozambique had to implement reforms suggested by the IMF, including the adoption of VAT. According to the ActionAid and Eurodad study, this led to an increase in the informal economy and an increase in corruption.<sup>24</sup> In Sierra Leone, Oxfam has recently expressed concern about the effect on food security of a tax applied in January 2010 to goods and services there. This tax was introduced as a condition of an IMF loan under the Poverty Reduction and Growth Facility (PRGF) programme.<sup>25</sup>

**In terms of equity, the underlying intention is quite clear: with a consumption tax on all goods, it was argued that wealth redistribution would occur mainly through public spending.** As a by-product of the efficiency achieved through a value-added tax, reformers also hoped that it would be possible to introduce a differentiated VAT for certain products, which would provide an opportunity to make the taxation more equitable. Essential goods or those most important to the poorest sections of the population could be subject to less tax or none at all. VAT could help shape developing economies, where the rural sector is very important; to avoid increasing the price of agricultural products, these could be exempted from VAT payments.

A parallel dimension that may help explain the strong push for indirect taxes was the trend towards policies that promoted a 'race to the bottom' and low taxation levels in order to attract private investment and maximise foreign direct investment (FDI).<sup>26</sup>

Many of these assumptions did not turn out as expected. Neither the likely impact on redistribution nor the negative impact on the poorest sections of the population were properly analysed prior to the introduction of VAT. Indeed, when it comes to the promotion of redistribution via public spending or the exemptions designed to promote foreign investments, many contradictions arise between the IFIs' doctrine on taxation and other IMF and World Bank policies. These issues will be explored in more detail in subsequent sections.

However, the IMF appears to be turning a corner on tax policy. A recently-issued paper states that improving tax policies is important for poverty reduction and achieving the Millennium Development Goals (MDGs);<sup>27</sup> that it is important to examine the distributional impact of tax reforms and to identify measures to address concerns raised; that greater efforts need to be made in taxing high-income individuals; that it recognises the pressures on revenue from trade liberalisation; that it is clear that IMF advice should not come in a 'one size fits all' form. The paper also makes reference to the problem of existing unjust corporate practice and how to avoid it. It remains to be seen how this will change the advice given by the IMF to country authorities.

### Box 2 IMF views on tax policy

- **Indirect taxes should be centred on end consumers;** this idea is best exemplified by VAT.
- **Indirect taxes should have a uniform rate.** If there are different rates, these should be determined on grounds of efficiency and equity. If efficiency is the only consideration, goods with inelastic demand (goods and services for which demand remains stable even if their price increases) would be heavily taxed. The tax burden for such goods and services falls mainly on consumers and on those who consume goods out of preference (for example, tobacco and alcohol) or out of necessity (salt), i.e. goods for which there are few substitutes.

However, for reasons of equity, when a product is a necessity and is disproportionately consumed by the poorest sectors of society, it should not be taxed or could be taxed at a lower rate.

- **Intermediate goods, that is, those that are used as components in final products, should not be taxed**, unless it is impossible to tax the final product.
- **Taxes on international trade should be lowered** as they distort markets. Rates for taxing trade should be equal to those on domestic goods competing with imported goods, intermediate goods should not be taxed, and protection will only be given to new industries if subsidising them is not possible.
- It is desirable to **tax the consumption of certain goods, which have a negative impact on the rest of the population** (tobacco, alcohol, road use, energy, etc.), and, by the same token, to promote those goods and services that have a positive impact through subsidies.
- Given that income tax is applied to all taxpayer income, it affects both consumption and savings decisions and, consequently, investment. **Taxing consumption is therefore more efficient since it only affects consumption choices.**
- More recently, tax incentives have been considered detrimental and distorting.

Sources: Our compilation based on Coady (1997)

## **International laxity: tax havens and lack of fiscal co-operation**

The use of tax havens means that huge amounts of potentially taxable resources in developing countries cannot be traced and are lost.

A report for Global Financial Integrity (GFI) (2011), asserts that even by conservative estimates, illicit flows of potentially taxable resources out of developing countries in 2008 were around \$1.26-1.44tn. Approximately half of these resources during the period from 2002 to 2008 were diverted through trade mispricing practices by multinational companies, while the remainder were lost due to corruption and criminal activities.<sup>28</sup> Tax havens clearly encourage tax dodging and have become a black hole in international finance, allowing individuals and companies to escape from some of the financial and legal regulations in their home country. Quite apart from the low or non-existent levels of taxation in these jurisdictions, tax havens make it easy to create shell companies and trusts,<sup>29</sup> which are then protected by high levels of financial secrecy. Most tax havens do not exchange tax information with other jurisdictions and few recent information exchange agreements signed with tax havens have proven effective so far. That is why they are now more and more referred as 'secrecy jurisdictions'.<sup>30</sup>

Since the 1970s, the increasing number of tax havens has undermined efforts to increase taxes on the rich and on multinational companies based in developing countries, along with other emerging and developed countries. Neither international institutions nor developed country governments have attempted to regulate tax havens with any real determination. The OECD has been given the role of dealing with secrecy jurisdictions and, more specifically, with setting international standards for the exchange of tax information between jurisdictions. In 2009, the OECD's attempt at classification clearly showed the ineffectiveness of its approach: in order not to appear on the initial blacklist of uncooperative jurisdictions, states only needed to sign 12 bilateral tax agreements (Tax Information Exchange Agreements – TIEAs, or double taxation agreements – DTAs). No conditions were applied regarding the characteristics of the signatory states and no mechanisms were established to identify whether requests for the exchange of fiscal information under bilateral agreements were later fulfilled.

The OECD has also been mandated by the G20 to undertake a highly political, time-consuming, and difficult monitoring process in the form of a peer review mechanism

which will assess national tax legislation in about 100 countries and make recommendations for improvement. Approximately 60 reports will be delivered by the end of 2011, but the full process of peer review by the Global Forum on Transparency and Exchange of Information for Tax purposes will not be finalised until 2014. While the methodology of the process is interesting, the outcomes remain to be seen. Meanwhile, no objective list of secrecy jurisdictions has been made available and none have been subject to any kind of sanctions. The OECD (and subsequently the G20) has promoted the bilateral tax information exchange agreements (TIEA) as a means of addressing global transparency and cooperation on tax issues, in spite of the fact that most developing countries remain outside the whole TIEA process, unable to negotiate such bilateral agreements. However, no effective proposal for a multilateral tax information exchange agreement has been implemented yet for developing countries despite the G20 commitments. Furthermore, the efficiency of the proposed model of tax information exchange proposed by the OECD, putting the burden of the proof on the requesting country, has yet to be proven for both developed and developing country tax administrations.

It is undoubtedly multinational companies that benefit the most from tax havens. The vast majority of multinational groups only provide consolidated global accounts, with no basic information on their activities in each country of implementation. Their complex corporate structures, involving hundreds of subsidiaries, allow multinational groups to reduce their tax bill at the global level. In 2010, GFI made a conservative estimate that developing countries' annual tax revenue losses attributed to trade mispricing practices were likely to amount to \$98–106bn from 2002 to 2006, roughly the amount of ODA at that time.<sup>31</sup> These estimates only concern the tax evasion practices of export under invoicing and import over invoicing between related or unrelated companies.<sup>32</sup>

Intra-group transactions are frequently used to reduce a company's perceived profits. Some of these transactions often bear no relation to external market conditions: thin-capitalisation of subsidiaries or payments of services to subsidiaries located in tax havens that are happening elsewhere. In 2007, *the Guardian* newspaper calculated that the three largest banana companies in the world paid an average of 14 per cent in taxes on their profits, despite the fact that the headquarters of all three were located in the United States, where statutory corporate tax on profits is 35 per cent. Payments inside the groups were made to Cayman Island, Bermuda, or Luxembourg for services including procurement, distribution, and financing costs.<sup>33</sup>

Sometimes intra-group transactions are manipulated (known as 'transfer mispricing') to increase the costs in producing countries and divert profit to tax havens, where the group is taxed at a very low rate. Tax administrations in developing countries have very limited resources for monitoring the real level of profits that should be attributed to multinationals. When profit-shifting occurs through subsidiaries in tax havens, with whom tax cooperation is difficult, developing country, and even many developed country, tax administrations face a daunting challenge in undertaking audits of large multinational groups. The lack of transparency in consolidated accounts prevents an accurate calculation of the revenues accrued by a company in a given country and makes any real attempt to monitor transfer-pricing a farce.

## **Liberalisation and deregulation of international trade**

During the 1990s and 2000s, the IMF, World Trade Organisation (WTO), and World Bank promoted the liberalisation and deregulation of international trade. This has led to either the reduction or total elimination of taxes on imports in many developing countries. Indeed, developing countries remain under considerable pressure to further liberalise their economies – for example, by removing tariff barriers and deregulating rights of

establishment.<sup>34</sup> This deregulatory pressure is reinforced by regional economic integration in the form of customs unions, free trade areas, and free trade agreements.

Pressure to deregulate is strongest in Africa, maybe because here (and in South Asia) average import duties are much higher than in other regions. In addition, taxes on trade are expected to be further reduced in sub-Saharan Africa, as a result of the formation of free trade areas and customs unions within the region and agreements made with other regional trading blocs, including the European Union. At present about one-third of tax revenues not related to natural resources in the region come from trade taxes (equivalent to 4 per cent of GDP).<sup>35</sup>

In order to attract FDI, international institutions have also promoted bilateral investment agreements with tax conditions that are very advantageous to investing companies. This has created a race to the bottom, again with grave consequences for developing countries. There now seems to be some correction underway, although the final impact of this and whether it will result in a definitive change in trends has yet to be assessed. Most of these bilateral investment agreements prohibit the recipient country from introducing any performance requirements or any type of restriction to the free repatriation of the investor's profits. Foreign investors are often exempted from having to abide by any regulations that are introduced in the recipient country after the investment project has started (even if national investors have to comply with these).

Only foreign investors can resort to international arbitration courts in cases of conflict with the recipient state if they wish to seek payment of market value damages (including both actual losses and anticipated future profits). These international investment treaties not only compromise the sovereignty of developing countries but also hamper the ability of their governments to address human development or sustainability. Too often, they also represent a severe drain on developing countries' public funds.<sup>36</sup>

In addition to IFI conditionalities and the pressure from international investors, it should be noted that in many cases, developed country governments have also hampered the tax reforms promoted by developing country governments.<sup>37</sup>

## 4. Domestic limitations and constraints

**Several significant domestic limitations and constraints have adversely affected the ability of developing countries to generate enough revenue through tax collection for the fight against poverty.**

Given the fiscal models on which tax policy is constructed and the assumptions that underpin such models, the option of using taxation policy as a tool to combat inequality and to correct the socio-economic imbalances which have resulted from prevailing growth models is limited. This section will explore the different obstacles developing countries face stemming from:

- the specific policies adopted;
- the lack of tax incentives rationalization;
- the existence and, in some cases, growth of, informal economic sectors;
- the institutional weaknesses in developing countries that make it hard for them to challenge those policies and avoid the diversion of resources;
- a lack of coherence between the tax system at national and regional levels.

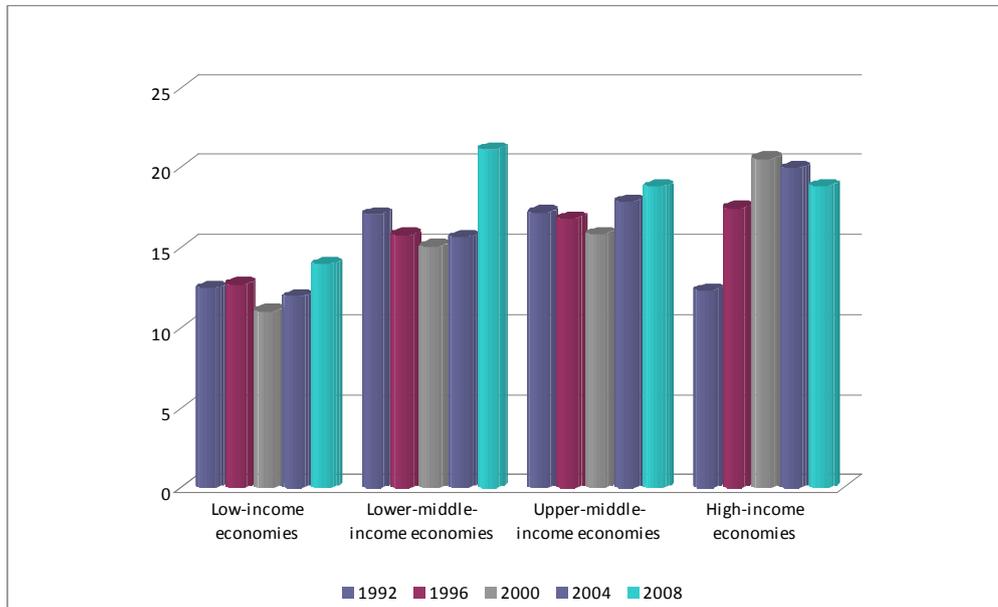
### The applied design of tax policy

In recent decades numerous tax reforms have been promoted in developing countries. However, there is a widespread feeling that due to the particular conditions in these countries and the one-size-fits-all nature of reform formulas, many problems persist, both of a general nature and specific to each tax.<sup>38</sup>

The recent reforms to tax systems share a number of common policy foundations and objectives. The first has seen efforts to dramatically increase the importance of VAT. The second has involved simplifying tax systems and applying low nominal tax rates to companies' financial results and personal income, in order to promote savings and investment. Third, taxes on international trade (imports and exports) have been reduced or eliminated.<sup>39</sup>

The results based on the fiscal accounts of developing countries are the best proof that these reforms did not turn out as planned (see Figure 1).

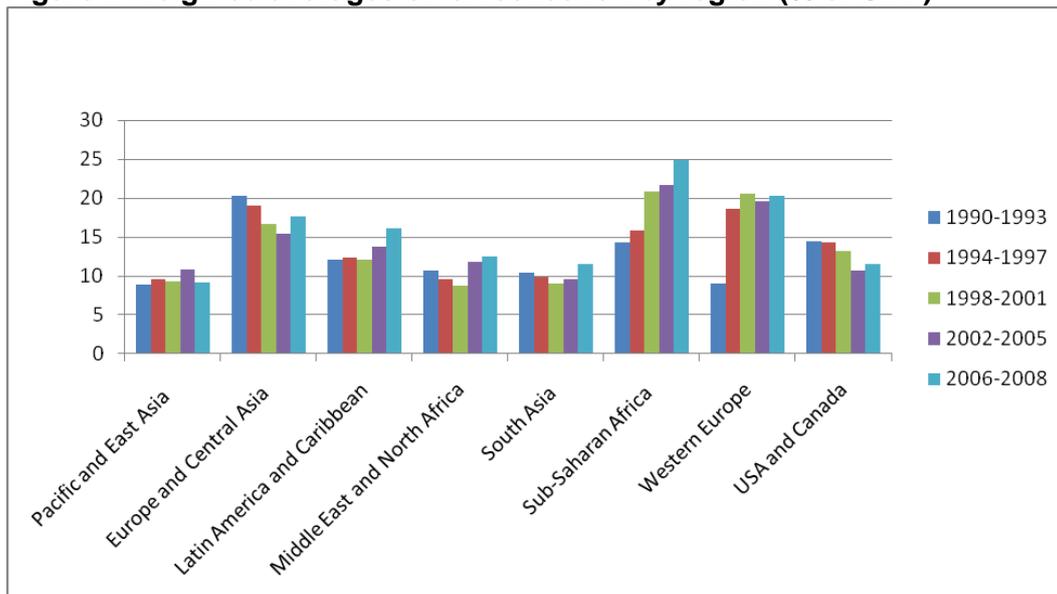
**Figure 1 Average simple tax revenues (% of GDP)**



Source: Our compilation based on World Bank data.<sup>40</sup>

An analysis of regional tax to GDP ratios gives the impression that little has changed. In fact, when the apparent increase in collection that sub-Saharan Africa underwent in the 2005–08 period (Figure 2) is analysed, we find that the ‘South Africa effect’ – i.e. the data from a middle-income country – has skewed the results for the whole region.<sup>41</sup> The data from this region is also skewed by the impact of countries whose economies depend on extraction industries. For example, in 2007, approximately 42 per cent of the tax ratio of African countries was due to taxes associated with natural resources<sup>42</sup> at a time when the price of oil and many other natural resources was increasing.

**Figure 2 Weighted averages of tax collection by region (% of GDP)**



Source: Our compilation based on World Bank data.<sup>43</sup>

## **A. Corporate taxes**

Throughout the world – not only in developing countries – taxes levied on business activity have been in decline, falling from an average of 30–50 per cent to 20–40 per cent.<sup>44</sup> This process occurred first between 1991 and 1999 and then again from 2000 to 2006.<sup>45</sup> In spite of the recent global economic and financial crisis having caused “fiscal constraints for many economies ... many are still choosing to lower tax rates on businesses...”<sup>46</sup>

The transition countries of central and eastern Europe and central Asia have the lowest taxes: Latvia – 15 per cent, Hungary – 16 per cent, Bulgaria – 10 per cent, Romania – 16 per cent, Montenegro – 9 per cent, Serbia – 10 per cent, Armenia and Russia – both 20 per cent.<sup>47</sup>

In sub-Saharan Africa, formal business tax rates range from 25 per cent to 40 per cent, much higher than the OECD country average of 25.8 per cent.<sup>48</sup> Apart from Chile, business tax rates in Latin America and the Caribbean are comparable to those in sub-Saharan African countries.

Although the drop in corporate tax has been a global trend, the reduction in these taxes in most developed countries has not resulted in a reduction in tax revenue overall. In developing countries, however, tax revenue has fallen. According to some estimates, between 1990 and 2001 the reduction in corporate taxes accounted for a fall of close to 20 per cent in the income of these countries.<sup>49</sup>

In OECD countries the reduction in taxes has generally been accompanied by a reduction in exemptions and deductions, as a result of which the tax base has been broadened rather than reduced.<sup>50</sup> The exact opposite has occurred in developing countries where the business tax base has effectively been reduced by tax holidays and reduced tax rates for specific sectors or regions, among other factors.

## **B. Personal income taxes**

Many countries are simplifying the taxation of personal income, eliminating the very high tax brackets (through reducing the percentage that is levied on each additional increment of income beyond a certain level) and levelling the tax rate structure. In extreme cases, some economies in transition are moving away from conventional systems of progressive taxation toward other models, such as a single-rate (or flat-rate) system. For example, in 1994, Estonia was the first country to introduce a flat-rate tax, replacing a system that taxed income at rates from 16 to 33 per cent with a single 25 per cent rate.<sup>51</sup>

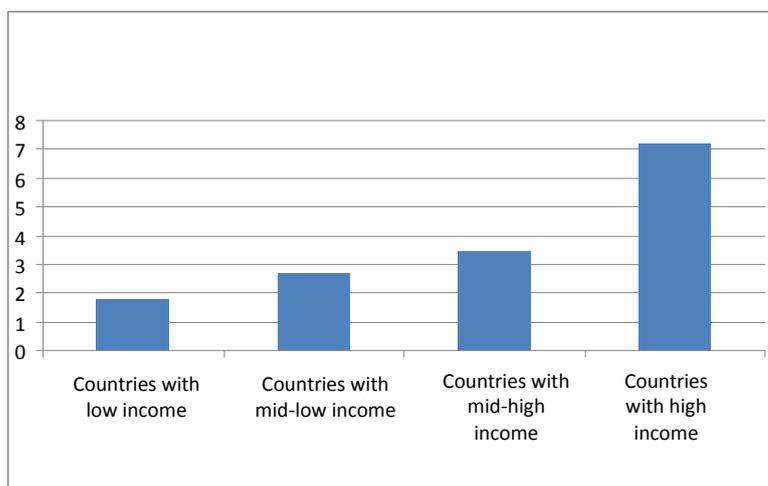
Although the equity of a single-rate system is questionable, it is promoted as a way of improving tax collection rates. However, the outcomes do not always support this theory. In recent cases, the introduction of a single-rate system has resulted in a drop in income tax collection<sup>52</sup> (with the exception of the Russian Federation, where collection increased, although in the context of dramatic economic growth). To these results should be added the potential loss of progressive taxation that accompanies this model.

In general, developing countries are making progress with simplifying tax administration and collection and are improving the alignment between business and personal income taxes.<sup>53</sup> There has also been a slight increase in the proportion of total revenues derived from personal income taxes, to the point where these revenues now come closer to the tax income received from business taxes. In sub-Saharan Africa, however, income from personal taxes is almost twice the income from businesses, including social contributions. For countries in this region, without disaggregated data, the ratio may be close to 1:1.<sup>54</sup>

However, this data should not detract from the fact that in developing countries revenue from income tax is still excessively low compared to OECD countries. As Figure 3 shows, the revenue from personal income taxes still accounts for less than 2 per cent of GDP in

low-income countries. This is partly because these taxes are often difficult to manage, but also because the structure of taxation tends to reflect political commitments, including multiple brackets and generous tax breaks and deductions that benefit those with the highest income.

**Figure 3 Revenues from personal income taxes (% of GDP)**



Source: USAID (United States Agency for International Development) Fiscal Reform Project 2008-09 ([www.collectingtaxes.net](http://www.collectingtaxes.net), accessed July 2010)

When one scrutinises the low revenues from personal income tax in developing countries more closely, it transpires – somewhat surprisingly – that in almost all cases, what tax revenue from personal income is produced comes primarily from taxes on wages. These may be the wages of those from the poorer strata of the population mainly working in the public sector, given that income from personal capital, such as interest or rents (i.e. non-wage income), is concentrated among the wealthier socio-economic strata.

**In Latin America, in particular, personal income tax is generally not applied to income and return from capital, which is heavily-concentrated in the high-income brackets.** This partly explains why personal income taxes produce so little revenue in this region (see Box 3). One way of expanding the collection base could be to broaden the taxable base so that it would cover all income, including profits and returns on capital.

### Box 3 Low personal income tax collection in Paraguay and Peru

**Paraguay:** Direct taxes only account for 2.2 per cent of GDP (a fifth of the amount represented by indirect taxes).<sup>55</sup>

Almost all direct taxes come from business (with a linear and proportional rate of 10 per cent). The government intended to implement an income tax reform (for individuals with non-business income greater than \$30,000 a year, at a maximum rate of 10 per cent), but after four years of strong opposition from powerful economic groups, this reform has been suspended until 2013 by Law 4064/10.<sup>56</sup>

In any case, so many deductions were to have been permitted that this tax would have been almost incidental. Those people obliged to declare an income of over \$30,000 a year can deduct family expenses for food, education, health, clothing, shelter, and even entertainment.

A striking point is that this legislation could even encourage tax avoidance since those exempted from paying it – i.e. most of the population – would be allowed to give or sell their deductible expense invoices to those who are required to declare their income.

**Peru:** Despite being very progressive when it was first conceived (three brackets of 15, 21 and 30 per cent, and a minimum bracket exempted), income tax does not bring in much revenue in Peru, primarily because of the enormous number of deductions and tax incentives. In 2008, a new reform reduced the taxation on income from capital to a fixed rate of 6.25 per cent (in force for the 2009 fiscal year). This reform was justified on the grounds that it would prevent capital flight to tax havens.

Sources: Our compilation based on various sources: Economic Commission for Latin America and the Caribbean (ECLAC) (2008), Finance Ministry of Paraguay (2010) and Finance and Economy Ministry of Peru (2010).

The situation is similar in sub-Saharan Africa. A wide-ranging study of the region affirms that in those countries analysed, interest payments by companies were considered to be expenses, thereby reducing the taxable income. As a consequence, entrepreneurs preferred to finance their investments or transactions through other methods, such as personal loans, instead of using their own capital. People also assumed that they would somehow be compensated for the tax they had to pay on any interest earned from their capital through taxation at the final consumer or personal level. However, in developing countries, income from interest is not generally taxed at a personal level or is taxed at a rate far below the average applied to businesses, whether as a result of explicit policies or because the tax authorities lack the ability to monitor these income flows.<sup>57</sup>

Alongside Kenya and South Africa, Ghana has one of the few successful tax systems in sub-Saharan Africa in terms of tax to GDP ratio. Here, the largest component of the tax system is direct tax on personal income and business activity. However, other forms of direct taxation – on capital gains, property, and rentals – contribute extremely little to the generation of public revenue.<sup>58</sup> In terms of revenue, business taxes and personal income taxes in Ghana contribute the same proportion to the total collected. However, 88.7 per cent of income tax revenue comes from taxation of wage income.<sup>59</sup>

In Accra, the Ghanaian capital, rental and property prices are very high compared with the low income-levels of most citizens.<sup>60</sup> Some estimates indicate that taxing this sector could represent between 1 per cent and 2 per cent of Ghana's GDP (with the added benefit of clarifying matters relating to property).<sup>61</sup>

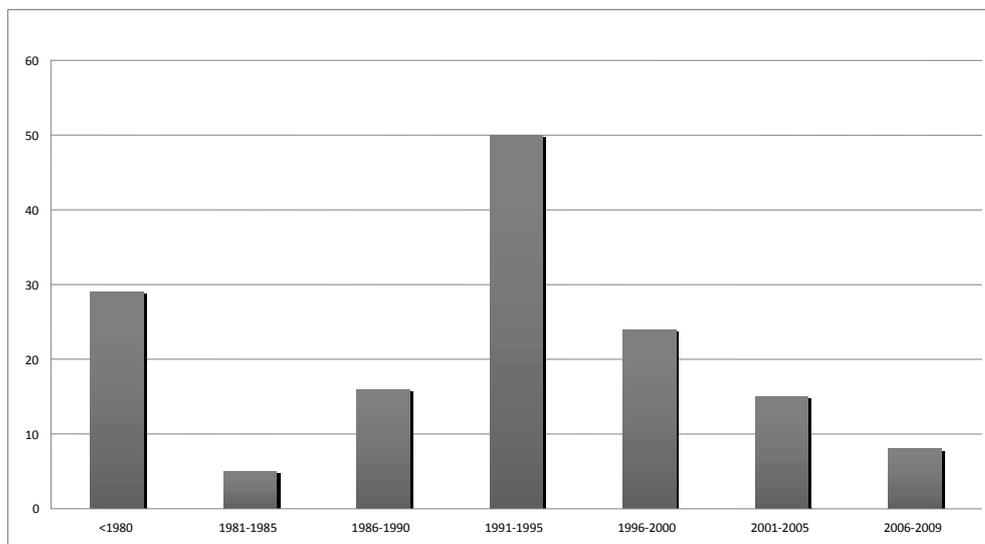
### ***C. Indirect taxes***

**In general, taxes on consumption have become the main source of tax revenue for developing countries and economies in transition.**

In the regions of Africa and Asia Pacific, indirect taxes grew from 4.6 per cent of GDP in 1990 to 5.4 per cent in 2002, while in Latin America and the Caribbean they increased from 4.1 per cent to 8.8 per cent of GDP over the same period. In Ghana, VAT represented 6.7 per cent of GDP in 2009 and 27.6 per cent of tax revenues;<sup>62</sup> in Senegal, it represented 7.2 per cent of GDP in 2009 and 41 per cent of tax revenues.<sup>63</sup> In 2008, in Bolivia, Paraguay, Peru, and Ecuador, VAT accounted for 42 – 52 per cent of tax revenues.<sup>64</sup>

Tools such as VAT that levy tax on consumption were the standard policy in developing countries during the last wave of reforms, especially in the 1990s.

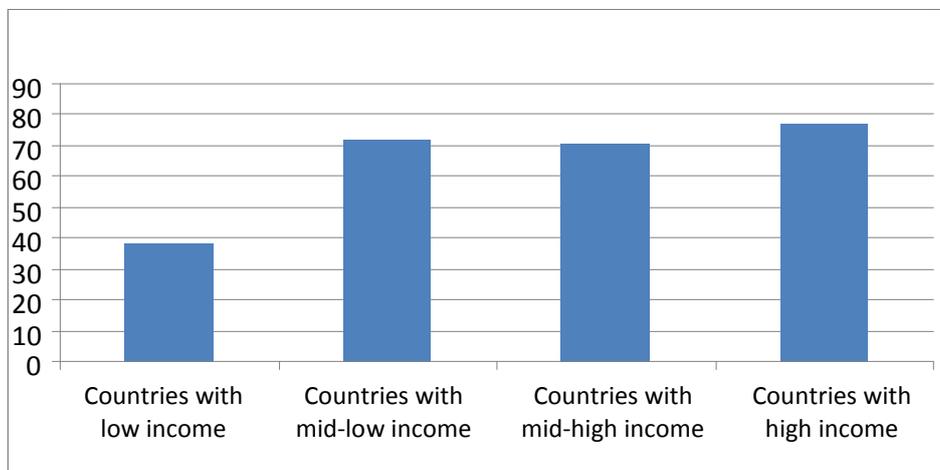
**Figure 4: Number of countries where VAT was introduced**



Source: USAID compilation (Fiscal Reform Project: [www.collectingtaxes.net](http://www.collectingtaxes.net))

Overall, the countries which adopted VAT have undergone an increase in their tax to GDP ratio. However, as shown by USAID's data in Figure 5, the percentage of taxable goods and services is much lower in low-income economies.<sup>65</sup>

**Figure 5 VAT taxed goods and services as a percentage of total goods (2008–09)**



Source: Our compilation using USAID Fiscal Reform Project data (2010) ([www.collectingtaxes.net](http://www.collectingtaxes.net))

Like income tax, VAT has been subject to a significant number of exemptions, many of them intended to combat its regressive potential, but many others without a clear objective. Examples of goods and services that have been exempted from VAT in sub-Saharan African countries raise questions about the benefits they generate for these countries' economies, especially for their poorest citizens. They include fuel (Kenya and Uganda); tourist transportation (Kenya); supplies for the presidency (Malawi); services for restaurants and construction materials (Kenya); funeral services and postage stamps (many of the countries in the region).<sup>66</sup>

The case against the potentially regressive character of these taxes is growing, given the context in poor countries. Some of the strongest voices against the excessive use of VAT come from Shahe Emran<sup>67</sup> and the Nobel Prize winner Joseph Stiglitz. Although the basis for their position is theoretical, their criticisms are essentially about both efficiency and equity.

#### **Box 4 Stiglitz and Emran's arguments on VAT as an inefficient tax for developing countries**

- **VAT discriminates between formal and informal sectors, thus creating incentives for the informal market to replace the formal one.** It generates a differential in prices for the producer between the formal and the informal market for a given product or similar products; the formal producer must sell at the price of production plus VAT, while the informal producer's costs do not include VAT. Therefore, if both sell at the same price, the informal producer will earn extra profit, because he or she does not pay any VAT.

Consumers will prefer to buy in the informal sector, triggering a drop in tax revenue.

- **The implementation of technology is a feature of the formal sector, a key factor in terms of improving productivity in the economy.** Because VAT harms the formal sector, it will also affect the level of technological integration and therefore the economy's potential long-term growth.
- **VAT could discourage market growth in rural sectors, preventing their advance.** By taxing intermediate goods and not final products, VAT could discourage the incorporation of technology in this sector, since final products in the agricultural sector are not taxed or are taxed at a very low rate (to avoid price rises).

For example, potato producers cannot charge VAT on the product's final price, because VAT on food items is zero-rated. However, when they buy fertilisers or machinery, they must pay the corresponding VAT. As the machinery is an intermediate good in the potato production chain, VAT paid by the producers will generate a credit for them (VAT credit). However, this credit in the producers' favour may not be redeemable in some cases<sup>68</sup> and the producers may have no way of recovering the tax paid.<sup>69</sup>

Sources: Our compilation using and Stiglitz and Emran (2007)

Comparing the results of the introduction of VAT with the forecasts on which the reforms were based, it could be said that VAT's performance has been very patchy in developing countries, particularly in lower-income countries. For this reason, there should be a complete evaluation of VAT's performance in these countries, which, at the very least, should take into account the impact of the collection increase and the questions that might affect the progressive nature of the tax system as a whole. With respect to the tax system's progressive nature, the VAT modality adopted in each country should be analyzed (exemptions, tax range, etc.), as well as the mix of taxes that make up the tax system in general and the main beneficiaries of the public spending policy.

It is likely that VAT requires greater tax administration capacity than is available in developing countries. In terms of administrative costs to the state, it is possibly more expensive to maintain a VAT scheme than one founded on international trade taxes. This is based on the assumption that international trade taxes are processed when goods go through customs, while charging VAT requires a fiscal body with enough technology to monitor the transactions of all companies within its remit.<sup>70</sup> In addition, a recent study undertaken by the World Bank Group and PricewaterhouseCoopers International found that VAT takes companies much more time to comply with than income taxes. In Kenya, for example, a total of 393 hours were needed (equivalent to nearly ten weeks of full-time work) to comply with tax regulations. The majority of this time (276 hours or nearly seven weeks) was spent on VAT.<sup>71</sup>

Clearly, reforms based only in an increasing incidence of VAT were not the appropriate choice for all developing countries. The high levels of exemptions may have reduced the potential of VAT to increase revenue (the complete opposite of the scenario envisaged), while the assumption that it would provide for formalisation of the economy has not been fulfilled. It is interesting to note that if the increase in collection as a proportion of GDP is analysed for the year after implementation of a VAT, countries such as Benin, Botswana, Guinea, Madagascar, Mali, Mauritius, Nigeria, South Africa, Tanzania, Zambia, and Sri Lanka all experienced a drop in revenues (although this cannot be attributed solely to the impact of this tax as the nature of the tax reform package implemented and the specific context in each country may also have affected tax revenues). Two years after its implementation, only Benin, Madagascar, Mauritius and Nigeria had experienced any growth in collection. Five years later, Botswana, Guinea, Mali, South Africa, and Zambia remained in the same situation.<sup>72</sup> Moreover, as previously mentioned in the case of Mozambique, complex compliance requirements can push more people into the informal sector and increase corruption, while problems with the administration of VAT refunds can unintentionally harm the poor.<sup>73</sup> According to a report by IMF researchers,

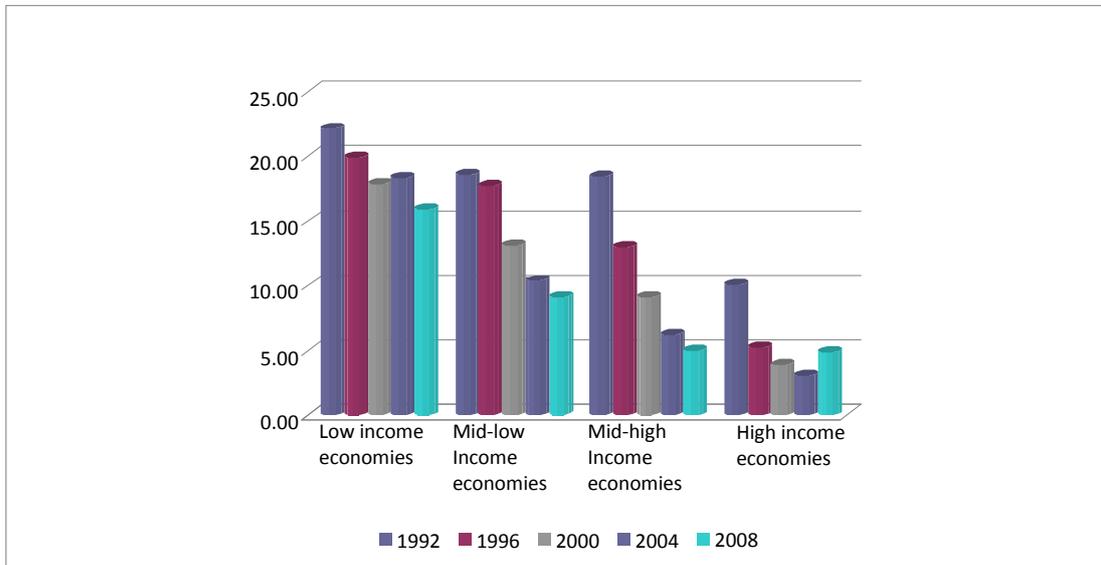
...Tax systems in Central America are generally regressive. While the richer segments of the population pay the bulk of the taxes, just as in other parts of the world, the poor pay more taxes relative to income...<sup>74</sup>

Although the authors support the idea that redistribution should occur mainly through public spending, they also recognise that '... [the] degree of overall tax regressivity varies substantially across Central America. In El Salvador, Honduras, and Nicaragua, the burden of taxation falls disproportionately on the poor (...) In El Salvador, for instance, the poorest quintile of the population pays more than two and a half times as much taxes relative to their income as the average citizen, and three and a half times what the richest quintile pays...' Significantly, the report asserts that '...[in] El Salvador, the poorest 20 per cent of the population pay over three times more VAT relative to their income than the average household in the country and five times as much relative to the richest 20 per cent...' VAT or sales taxes are the single most important source of tax revenue for most of the Central American countries that were analysed.

#### ***D. Taxes on international trade***

This is the most challenging category of tax which public budgets have to face in developing countries. Both taxes on international trade (on exports and imports) were drastically reduced in developing countries through the trade liberalisation measures progressively adopted via the WTO. Before these measures were enacted, taxes on international trade represented a significant proportion of tax revenues for many poor countries.

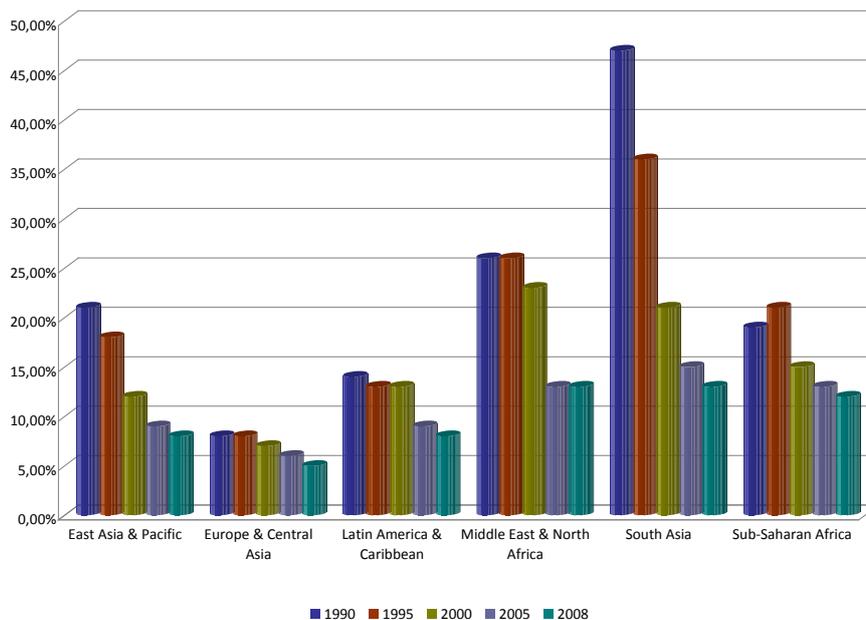
**Figure 6 Taxes on international trade as a percentage of total tax revenues (%)**



Source: Our compilation with World Bank data

Duties on imports were also reduced, with the expectation that the implementation of VAT would compensate for the loss in import duty revenue. So as not to affect the effective protection of certain products, a uniform reduction of duties on all goods was recommended. Meanwhile reformers argued that to obtain the revenues previously provided by the duties, VAT should be increased in proportion to the reduction in import duties through measures such as eliminating all exceptions and increasing tax on specific consumer goods (e.g. luxury goods).

**Figure 7 Taxes on imports by region (simple average of nominal rates)**



Source: Our compilation with World Bank data

Once again, however, developing and developed countries have had different experiences. Although most middle-income and high-income countries have been able to replace the loss of revenue resulting from the drop in trade taxes, research suggests that most low-income countries have only recovered a fraction of the losses and only in a very few cases have they been fully recovered.<sup>75</sup>

The OECD continues to recommend a deepening of reforms in the direction of free trade and the substitution of trade tariffs with other taxes, notably property taxes, as long as the administration has enough information at its disposal for the latter to be effective.<sup>76</sup>

In Box 5, we can see that despite reforms, Nicaragua still has a long way to go in implementing a more progressive tax system.

### Box 5 Has Nicaragua's tax system become more progressive since the reforms?

Over 12 years the tax to GDP ratio in Nicaragua increased from 12.3 per cent in 1995 to 13.4 per cent in 2002 and 18.1 per cent in 2007, thanks to a series of tax reforms introduced in 1997, 2002 (Tax Base and Expansion Law) and 2003 (Tax Equity Law), and to improvements in the administration of the tax system.

The tax reforms occurred in a context of serious economic and fiscal stress, further complicated by political instability resulting from conflicts between the executive branch of government and the dominant parties in the national assembly. Although the approval of the 2002 and 2003 laws was a major cause of the conflicts, the laws were essential for reaching new agreements and establishing a new programme with the IMF (under the PRGF framework for countries included in the HIPC).

Both tax reforms followed IMF recommendations and focused on the pursuit of tax revenue, given the urgency of addressing the large domestic debt. In 2000, Nicaraguan debt amounted to 180 per cent of GDP and net debt flows (payments) were 12 per cent of GDP. By 2008, the debt had fallen to 55 per cent and net debt flows to 2.2 per cent of GDP.<sup>77</sup> The reforms had prioritised major improvements in tax collection in order to cover the expansion of the debt's fiscal requirements.

Despite these reforms, the Nicaraguan tax system is still dominated by indirect taxes (VAT, excise tax<sup>78</sup> and customs duties on imports), which represent an average of 68.5 per cent of total tax revenues. Direct taxation, represented by income tax, increased from 13.68 per cent of overall tax revenue in 1995 to 30.39 per cent in 2007.

In the wake of these reforms, the key question is: **what has been their impact on equity and progression in the Nicaraguan tax system?**

Studies<sup>79</sup> on the wealth distribution impact of the Nicaraguan tax system prior to the reforms of 2002 and 2003 noted that the after-tax Gini coefficient<sup>80</sup> (0.6923) was considerably worse than the pre-tax Gini coefficient (0.5103).

The only study carried out so far of the reform of 2003 concludes that if regular consumption is used as an indicator of well-being, then the reform has had a moderately progressive incremental impact, with the greatest relative tax pressure falling on the highest consumption quintile.<sup>81</sup>

However, if the indicator of well-being is income, the reform's distributional impact is basically proportional: each quintile sees an incrementally increased tax pressure on its income in approximately the same proportion. Therefore, the reform has left the pre-reform distributive inequality unchanged (see Table 2).

**Table 2 Impact of the 2003 Nicaraguan tax reform**

	Consumption distribution (% of total)	Equivalent income (% of total)	Reform's tax burden distribution	Tax pressure according to consumption distribution	Tax pressure according to income distribution
Quintile 1	6.2	4.1	3.4	0.5	0.8
Quintile 2	10.6	7.6	7.9	0.7	1.0
Quintile 3	14.8	11.5	10.9	0.7	0.9
Quintile 4	21.3	18.4	18.6	0.9	1.0
Quintile 5	47.1	58.5	59.2	1.3	1.0
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>		

Whichever of the two indicators of well-being is used, the incremental tax burden resulting from the reform or its distributional impact does not markedly alter the regressive character of the tax system that existed before the reforms were introduced. Reversing this would mean, on the one hand, raising the incremental tax burden imposed on the sectors with the highest concentration of income to bring it closer to the average tax burden, and, on the other hand, not increasing the burden on the majority of the population with a lower income.

In principle, an increased role for income tax could reduce regressiveness in the tax system. But this is not necessarily the case, as the largest income tax contribution comes from the tax on corporate income.

Since 2003, corporate income tax collection has increased, partly because of the introduction of a minimum payment of 1 per cent on companies' gross assets. This measure was designed to prevent tax dodging in a context where around 60 per cent of companies had been systematically reporting losses. Under this reform, companies pay whichever income tax amount is higher: either 30 per cent of net company income or the minimum payment of 1 per cent of gross assets. The minimum payment must be made, even if the companies report losses.

In reality, the application of this charge reflects the constraints facing Nicaraguan tax authorities, such as the endemic lack of political will to reduce evasion, to broaden the corporate income tax base (by eliminating exemptions, for example), and to align nominal or legal taxes with the taxes that are actually charged.

The personal income tax system is made up of six income brackets with a structure that is progressive insofar as the higher the bracket, the higher the rate applied. The first bracket is taxed at a zero rate and covers up to 50,000 córdobas (\$2,340) per year, while a marginal rate of 30 per cent applies to the highest bracket, 500,000 córdobas (\$23,400) and above.<sup>82</sup>

Some 78.5 per cent of wage earners are covered by the lowest bracket and are therefore exempted from the tax, as are Christmas bonuses and social security payments. But even with 78.5 per cent of employees exempted, personal income tax revenue is derived almost entirely from the income or earnings of salaried workers (99 per cent). Indeed the increase in revenue from this tax between 2001 and 2006 was due almost exclusively (70 per cent) to the fact that the 50,000 córdobas a year exemption bracket was not adjusted for inflation. With the minimum bracket remaining frozen at the 1997 rate of 50,000 córdobas a year, a growing number of employees had to pay this tax as their nominal incomes increased to above the minimum income level in line with inflation.

On paper, Nicaragua levys income tax on the income of employees or self-employed professionals, as well as on income or personal revenues, whether wages earned, capital gains, or a mix of the two. In reality, however, capital income or gains are largely exempt from the taxable income tax base or are not a part of it.

It is also worth noting that income tax is still based on the concept of territorial income, which means that income generated overseas is not taxed since it is 'worldwide income'.<sup>83</sup>

Source: Acevedo (2009)

## The cost to states of using tax incentives

The term 'tax expenditure' refers to the exemptions, credits, deductions, deferrals, and refunds that some taxpayers can benefit from and which can be considered a cost to the state. In general, tax expenditure is the result of preferential and differential treatment towards a specific sector, branch, region, or group of taxpayers that represents a deviation from the basic tax system. .

A lack of data and an inconsistency in recording methods makes tax expenditure difficult to analyse. Nevertheless, it seems important to try and compare developing countries' tax expenditure data (Table 3) with the real benefits that should have been generated by tax breaks in terms of export income for the country and the creation of local employment.<sup>84</sup>

**Table 3 Estimates of tax expenditure (% of GDP) (various countries)**

	Direct taxes % GDP	Corporate taxes % GDP	Personal taxes % GDP	Indirect taxes % GDP	Total % GDP
India (2005)*	2.01	1.64	0.33	2.48	4.5
Bangladesh (2005)**	0.28	0.22	0.05	2.24	2.52
Colombia (2007)	1.6	1.36	0.24	1.92	3.52
Ecuador (2005)	1.2	0.4	0.8	3.4	4.6
Guatemala (2007)	5.28	0.93	4.35	2.63	7.91
Mexico (2007)	3.02	1.45	1.56	2.9	5.92
Argentina (2007)***	0.51	–	–	1.7	2.21
Brazil (2007)	1.11	0.45	0.66	1.18	2.29
Peru (2008)	0.29	0.1	0.18	1.76	2.05
Chile (2007)	4.21	0.9	3.31	0.76	4.97
Nicaragua (2010)****	–	–	–	–	6.6

Sources: Our compilation based on various sources.

\*/\*\* Bangladesh Bank (2006)<sup>85</sup>

\*\*\* No information available on Argentina

\*\*\*\* IEEPP (2010)

ECLAC (2009)<sup>86</sup>

Table 3 shows that the figures for tax expenditure vary from 2 to 8 per cent of GDP in the countries from which data was collected. The percentages for countries with a low Human Development Index (HDI), such as Guatemala and Nicaragua, are particularly striking. According to the Instituto de Estudios Estratégicos y Políticas Públicas (IEEPP),<sup>87</sup> Nicaragua exempted the equivalent of \$415.6mn (8.74bn córdobas) in 2008, all of it endorsed by constitutional articles, laws, and decrees. This figure was higher than both the 2008 budget of the health ministry (approximately 6bn córdobas) and Nicaragua's budget deficit in 2010. In the case of India and Bangladesh, the tax expenditure for 2005 was equivalent to 51 per cent and 31 per cent of their total tax revenues respectively. Such high rates of tax expenditure go beyond what might reasonably be expected to benefit society as a whole.<sup>88</sup>

An analysis of 40 developing countries studied in 1990 showed that:

- 50 per cent used temporary tax expenditures for investment
- 31 per cent granted tax incentives for exports
- 40 per cent used reduced taxation rates
- 18 per cent had free trade zones

By 2001, these figures had increased to 58 per cent, 45 per cent, 60 per cent and 45 per cent respectively. Almost every country in sub-Saharan Africa offers tax holidays, while in Latin America and the Caribbean there has been a major proliferation in this type of stimuli.<sup>89</sup> In some countries, temporary tax exemptions, such as free trade zones, are granted for five years and in others for 15 years. Sometimes taxation continues to be reduced by 50 per cent after the total temporary tax exemption has expired, as in Burkina Faso.<sup>90</sup>

Such measures are justified by developing country governments on the grounds such incentives will lead to an increase in value-added exports and more and better

employment. However the evidence suggests that this seldom happens. In contrast to the spread of these fiscal tools in the developing world, empirical analyses do not conclusively show their positive impact on development.<sup>91</sup>

In Central America, free trade zones have been exposed as havens for national capital allied with foreign capital to evade taxes. In the controversial case of Nicaragua, the government subsidises almost 60 per cent of the cost of investment in the tourism sector through tax expenditure but receives no part of the profits – not even in the form of training for the workers in this sector.<sup>92</sup>

As far as international financial institutions are concerned, there seem to be serious contradictions and gaps in their policies on tax incentives. In principle, the IMF and the World Bank are opposed to general fiscal incentives in developing countries, but their position is less clear when the incentives are designed to attract foreign investment.

The annual *Doing Business* report, published by the World Bank and supported by the IMF, states that low taxes are the optimum criteria for attracting investment.<sup>93</sup> In traditional fashion, the original version of this report put tax havens at the top of the list for offering the easiest and most suitable environment for businesses. In response to considerable pressure, the World Bank appears to have revised these indicators in future editions. Nevertheless, despite some progress (reflected in the exclusion of the ‘Employing Workers Indicator (EWI)’ from 2011 edition of the report), on 4 November 2010 the International Trade Union Confederation (ITUC) stated that,

Through its ‘Paying Taxes Indicator’, which was not modified in *Doing Business 2011*, the Bank continues to advocate that business should be exempt from all forms of taxation, whether it is corporate income tax, social security contributions, property tax, capital gains tax, or financial transactions taxes.<sup>94</sup>

In the extractives sector in Africa, the World Bank has promoted what it calls a ‘strategy to reduce the risk to investments’, advising governments that, ‘they would have to provide highly competitive tax packages and incentives to attract new high-risk exploration and investment from international companies’.<sup>95</sup> However, the tax regimes of two agreements signed with foreign companies in Sierra Leone on the extraction of iron ore and approved by Sierra Leone’s parliament in 2010 have been strongly criticised by civil-society organisations. The London Mining Agreement includes numerous exemptions that are inconsistent with Sierra Leone’s own Mines and Minerals Act of 2009, such as 10-year discounted corporate tax rates and unfavourable royalty terms. On top of these, a stabilisation clause could extend tax benefits for another 15 years.<sup>96</sup>

Another aspect of IMF tax policy which remains unclear (in spite of recent improvements) is its resistance to salary increases on the grounds that low salaries give a country a competitive advantage. This can be seen as yet another fiscal sacrifice that developing countries must make in order to comply with IMF stipulations. In fact, there is evidence to suggest that *more* rather than *less* public resources are a prerequisite for attracting value-added investment and creating better socio-economic conditions for the population, as confirmed by experiences in Malaysia and Singapore.<sup>97</sup>

As can be inferred from statements made by the ITUC, the *Doing Business* report has also played its part in promoting unfair labour policies in poor countries:

By considering labour regulations only from the view of whether they are deemed to be good for business, the World Bank has caused enormous damage to workers ... The Bank should carry through on the positive step it has made in *Doing Business 2011* ... and, instead, adopt policies on labour issues that recognise and reward the importance of adequate labour regulations and comprehensive social protection...<sup>98</sup>

The stated aim is to increase the tax base in countries with a large informal economy, however the World Bank has not propose policies that would

encourage fairer formalisation, such as an improvement in monetary and non-monetary benefits to workers.

## Informal economy and informal workers

Out of the three billion workers in the world, nearly two-thirds, 1.8 billion people, work in the informal sector. In some developing countries the proportion of casual employees can amount to more than 50 per cent of the jobs outside agriculture, and over 90 per cent if agriculture is included in the estimate.

The highest rates of informal work can be found in sub-Saharan Africa. In Benin, 97.2 per cent of working women are part of the informal economy. The next highest rates can be found in South-East Asia and Latin America where economic growth over the last 30 years has been accompanied by growth in the informal sector.<sup>99</sup> According to the data available, in South America informal non-agricultural employment for women has increased much more than it has for men, rising from 47.5 per cent in the period 1990–1999 to 55.4 per cent in 2000–2007.<sup>100</sup>

In Mexico, only 30 per cent of small companies (firms with 10 or fewer employees) are registered. The situation is even more dramatic in El Salvador where only 1 per cent of all micro-enterprises and 3 per cent of other companies are registered.<sup>101</sup>

Martinez-Vasquez and Terkper estimates that the losses from not taxing the informal sector could amount to 35–55 per cent of tax revenues collected in some developing countries.<sup>102</sup> The challenge is to tackle this problem in a just way, analysing the factors underlying this situation and the different aspects of black market work,<sup>103</sup> otherwise a legitimate attempt to tax the informal sector, in order to increase revenues in developing countries, could lead to policies that exacerbate poverty and increase the vulnerability of certain sections of the population.

People who join the swelling ranks of the informal sector do not pay taxes to the state, but given the close correlation between informality, poverty, and vulnerability, nor can they count on the protection mechanisms that should be provided by the state. Approximately 700 million informal workers live in extreme poverty, surviving on less than \$1.25 per day. Their poverty is reflected not only in their lack of income; most informal workers are vulnerable to health problems and work in unsafe conditions.

Young people in developing countries, who in theory will be part of the future tax base, constitute a large proportion of the informal economy and enjoy very few rights and opportunities. In 2008, 24 per cent of the world's working poor were youths. In developing countries they are more likely to be among the working poor than adults.<sup>104</sup>

### Box 6 Defining informal workers

Informal workers in developing countries can be categorised in two main groups:

- **Informal workers in the informal goods and services sector**
  - self-employed workers and workers in family-run enterprises created for self-sustenance
  - micro-enterprises with less than five workers
  - workers in informal producers' co-operatives
- **Informal workers in the formal goods and services sector**
  - companies with five or more workers, many of whom have no social protection
  - workers with no regular employer, who sell their labour on a daily, seasonal, or irregular basis
  - domestic workers without social protection
  - subcontracted industrial workers, producing from their homes or small workshops

Sources: Our compilation based on various sources: OECD (2010a), Bonner (2006), International Labour Organisation (2010).

Recent studies indicate that informality is context-specific. Informal workers exist in a variety of scenarios, as described briefly in Box 6. With some certainty, one could say that informal markets, such as the Polvos Azules market in Lima, Peru,<sup>105</sup> the peddlers of Caracas, Venezuela,<sup>106</sup> or the La Salada market in Buenos Aires, Argentina,<sup>107</sup> all include informal workers, but of very different profiles and types.<sup>108</sup> Other distinctive features might be found in markets in sub-Saharan Africa, where workers may have a lower socio-economic status or where there may be less developed local productive networks.

A definition of informal workers should include an analysis of the reasons why people enter and stay in the informal sector. **Otherwise a just solution consistent with the fight against poverty and inequality may not be found.**

A significant proportion of informal workers are survivors of economic models that generated or reinforced social exclusion. Many are also survivors of precarious labour systems, of flaws in the focus of public social policies, or of corporate irresponsibility. Labour regulations play their part in condemning many working poor to job insecurity: in Zambia, for example, until 2006, casual workers were recognised in law but they could be fired with 24 hours notice and without any compensation.<sup>109</sup>

Others, however, have actively chosen to make their livelihood in the informal sector, perhaps because they have little confidence in the state as a provider of goods and basic social services or as an effective enforcer of the duty to pay taxes. Poor workers who live in remote rural areas or in an impoverished district of town may not see much point in working in the formal sector and paying taxes for public services, such as healthcare, that they cannot access.<sup>110</sup>

Differentiating between the circumstances of different groups of informal sector workers will enable the development of differentiated public policies that encourage formalisation or exploit the greater flexibility and adaptability of unofficial labour markets. In fact, in some circumstances, informal markets provide vital goods and services otherwise unavailable to the most vulnerable and the poorest.

Clearly, medium and large businesses that hide the true magnitude of their economic activities and make abusive use of insecure, informal employment relationships should be prosecuted and punished for both tax evasion and abusive labour practices.<sup>111</sup> However, a large proportion of informal workers do not fall into this category, which means that their formalisation for tax purposes should be undertaken with extreme caution.

Any increase in tax collection from the poorest and most vulnerable should be achieved as a final by-product of greater formalisation, based on the improvement of working conditions and the creation of decent employment.<sup>112</sup> Only after improving the poor's economic capacity, their potential for human development, and their political representation should an increase in their tax burden be considered. Otherwise the result may well be stagnation. Formalisation or the creation of decent employment should provide a way out of poverty, not reinforce it.

Not paying taxes excludes workers in the informal sector from having their interests legitimately represented. Paying taxes would allow them to access public services, loans, or social assistance in times of economic recession or in the event of extreme circumstances, such as bad weather.<sup>113</sup> Informal workers are easy victims of unexpected income loss,<sup>114</sup> as demonstrated by the recent economic crisis. In Latin America, for example, between the second half of 2008 and the same period in 2009, the number of self-employed persons increased by 1.7 per cent and the number of people working in family-run businesses by 3.8 per cent. The region also experienced a growth in the number of 15-19 year-old adolescents engaged in informal sector jobs.<sup>115</sup>

As the informal economy grows, so do the deterrents to meeting tax responsibilities amongst those who would otherwise be willing or obliged to pay the state for their economic activities or for the income they receive. As a result, a magnet effect is produced, presenting a serious challenge to public finances. The larger the informal labour market becomes, the easier it is for medium-sized and large companies to evade tax obligations, since they can always undervalue their actual earnings.

**The conventional battery of tax reforms implemented in developing countries has not addressed many of the underlying issues behind the growth of the informal sector.**

Administrative and logistical problems, as well as political obstacles, have been cited as the main hurdles to fully addressing this issue.<sup>116</sup> Some of those interviewed during the course of this investigation stated that in Latin America the people responsible for handling the informal sector within tax administrations consider this work demeaning.

‘They charge me 42,000 CFA francs per year’, complains Moussa, owner of a small stationery shop in Burkina Faso. ‘That’s more than the capital I have. What does the state offer me for this?’<sup>117</sup>

The failure to tax the informal sector presents a serious barrier to achieving optimum tax collection levels and therefore violates the rights of the poorest and most vulnerable sections of the population. However, measures taken to tax the more vulnerable, informal economy or enforce certain regulations are in many cases applied arbitrarily and inappropriately, in a way that can become violent and can fail to deal fairly with conflicting interests:

...The West Bengal government decided to phase out rickshaw pullers in Calcutta, India on ‘humanitarian grounds’. But for the rickshaw pullers this means a loss of livelihood.

In Cotonou, Benin, authorities attempted to regulate the motorcycle taxi industry by decreeing that drivers must wear yellow uniforms and making the wearing of helmets for drivers and passengers compulsory. They also tried to impose a tax and fulfilment of various technical requirements. Drivers did not have the means to meet all the requirements. It was at this time that they formed the union ... to defend themselves.<sup>118</sup>

Other ways of tackling this issue need to be explored and here it is worth commenting on Ghana’s experience in the transport sector (see Box 13 Ghana: opportunities for a win-win situation in the informal sector). Since 1987, co-operation between the Ghana Private Road Transport Union (GPRTU) and the government has advanced some ideas which, although far from perfect, are a basis for developing non-traditional mechanisms for addressing this issue.

## Institutional weakness

Domestic institutional weakness derives chiefly from the fact that tax administrations lack capacity. Poor co-ordination between different offices makes it difficult to properly penalise non-compliance, while perverse operating rules are often exploited by those seeking to maximise profits.

Institutional weakness promotes abuse and corruption in both the public and private sectors. It is also exploited and negatively reinforced by the laxity of international regulations which favour multinational companies’ poor practices. This results in revenue losses for both taxpayer and poorly-equipped tax administrations, no matter the fiscal policies they decide.

**The foremost manifestation of this weakness is the difficulty faced by tax administrations in monitoring and discouraging tax dodging by international companies and by the domestic private sector.** The Inter-American Development Bank (IADB) recently estimated the undeclared sales figures in many Latin American countries, highlighting some truly striking cases.<sup>119</sup>

Based on responses from some companies on the behaviour of others, the IADB report noted that the under-valuation of sales in order to evade tax liability is especially high in Brazil and Panama,<sup>120</sup> where under-valuation has reached about 40 per cent of total sales figures. The report also pointed out that the firms themselves have disclosed figures on tax payments, which suggest equally high or even higher levels of evasion. For example, in Mexico, only 9 per cent of micro-enterprises (firms with 10 or fewer employees) pay more than 50 per cent of what they should pay in taxes. Among small and medium-sized enterprises, the largest share, 63 per cent, are registered but report not paying taxes. In the case of large firms, 48 per cent do not pay taxes.<sup>121</sup>

### **Box 7 Tax avoidance using ‘creative accounting’**

For 23 years Exxon paid no income taxes for the exploitation of the Disputadas de las Condes copper mine in Chile. Year after year Exxon declared losses, thanks to ‘financial engineering’ techniques.

The cover-up operation was carried out via several methods. One consisted of writing off the interest on a loan as expenses – a loan that it had granted itself through a subsidiary registered in a tax haven (the widespread ‘thin capitalisation’ practise). On top of this, the company carried forward losses, making use of very permissive legislation. Of the total expenses that it declared, only 58 per cent corresponded to mining activity. The rest were financial expenses, depreciation, and indirect costs.

This is not an example of tax fraud – it illustrates the limitations of local institutions in monitoring avoidance, a situation made more serious by an international context that creates let-out clauses and incentivises poor corporate practices.

It should be emphasised that this situation also affects developed countries. ExxonMobil Spain, for example, benefited from a completely legal special tax regime whereby it paid zero tax on its profits of €10bn over the period 2008–09 (Jiménez 2011).

Source: Ibáñez (2002), Jiménez (2011)

A high level of tax dodging is also harmful to long-term future income, as it deprives the government of income to invest in public goods that are capable of increasing country aggregate productivity, such as infrastructure and education.<sup>122</sup> In this way, tax dodging creates, perpetuates, and reinforces poverty.

Poor technology, low wages for workers in the public sector, and the complex socio-economic contexts of developing countries are aggravating these circumstances. Tax administrations often lack the resources to obtain data on the ownership use and value of land or on land-related financial transactions, to give two examples. Likewise, it is difficult to keep track of economic activity when a large part of it is not formally registered. This precarious situation is a breeding ground for corruption and inefficiency.

Abuses also result from contradictory, badly-drafted laws or unclear rules of operation in the public and private sectors. The revision and rationalisation of these regulations is fundamental question that urgently needs addressing and which, as already noted, affects people working in the informal sector quite considerably.

We need to be clear about the different problems facing tax administrations in developing countries. On the one hand, there are flaws in the rules covering tax administration and how it relates to other bodies or levels of government, such as the institutions that penalise tax fraud. On the other hand, there are problems with the rules

that the tax authority is supposed to administer which then affect individual taxpayers (and non-taxpayers); and there are regulations haphazardly cobbled together (or lacking a proper regulatory framework in the first place) that promote abuse or are exploited by companies, such as the plethora of tax incentives and let-out clauses.

Complex and arbitrary systems continue to typify poor countries' fiscal systems, creating difficulties for taxpayers trying to fulfil their tax obligations and for small businesses that are obliged to meet the costs of employing accountants to deal with these complexities. Such costs are often one of the major hurdles to growth and a factor that perpetuates the informal or underground economy.

In order to pay its taxes in Latin America, sub-Saharan Africa or South Asia, a company has to go through an estimated 30 to 40 transactions on average per year. In high-income countries, the comparable figure might be between 10 and 20 transactions, spending around 177 hours a year on matters relating to tax payments. The time needed in countries such as Brazil, Bolivia, or Venezuela is estimated at around 2,600, 1,080 and 800 hours per year, respectively.<sup>123</sup>

### **Box 8 The impact of arbitrariness on small businesses**

The director of a Venezuelan micro-enterprise for over 20 years, gives us a clear indication of how poor-quality bureaucracy hinders the formalisation of small businesses:

'In Venezuela, establishing a business is a long and winding road. What in other countries takes a couple of months, in Venezuela today takes about eight, and that is for what is considered a "normal" company, a business trading in anything that is unregulated. If, on the other hand, it is a company in a regulated sector, obtaining the permits is a real hardship. Arbitrariness is absolute.

For example, our line of business is fire safety. We need to obtain certification and the requirements are well defined and clear, but when the official comes he could ask you for some document, and if you point out that this was not among the requirements listed, he can say that as a public official he can require you to produce whatever he considers pertinent. If you dare to go to his superior, you are seen almost as an enemy trying to discredit the management of the unit. This undoubtedly fosters the culture of corruption, arbitrariness, and impunity in which they operate.

After having gone through the stage of creating the company itself, one must add the process of compliance with legal obligations. This includes the INCE (National Training and Education Institute), housing policy, and social security.

Hiring or firing a worker is so cumbersome that you need at least a day for the procedure at each of the institutions; after this, you must proceed to make their standard payments: 15 per cent of their wage for social security, 2 per cent and 1.5 per cent of their wage for the INCE and Housing Policy. The payment is easy as you just have to go to the bank but you also have to have a certificate of payment for each of these steps... You have to get up at 4.00 a.m. for each procedure, the certificates are due quarterly or monthly and you may be asked for them at any time. If you do not have them, even if you have the payment receipts, you are not in compliance with the law and you are denied any permit.

With these three certificates you must go to the Ministry of Labour and request a labour certificate; if you do not have this, you cannot be contracted by the public sector. Currently even the private sector is obliged not to contract companies that do not have this certificate, with a penalty applied for doing so. We also have to pay the municipal tax, which is 1.6 per cent of total gross sales.

In the case of contracts with the public sector, one must make a contribution of 3 to 5 per cent of the contract amount to the social funds. In the case of PDVSA (Venezuelan Petroleum Co.) they only work with "social production companies" and, of course, there is a 30 per cent income tax on your profit.

Setting up your own company today makes it impossible for you to devote yourself entirely to your core business, as you have to be very careful of all the fiscal and semi-fiscal obligations that the government thinks up.

Furthermore, the existing labour immobility<sup>124</sup> means workers take it easy. This has been the situation for eight years and there's no end in sight.

All of this means that company informality mushrooms because you need such a complex structure in order to have a formal company...'

Source: Statement (interview) with a Venezuelan entrepreneur (anonymous for security reasons)

As Box 8 and other evidence shows, the regulatory environment is clearly a determining factor in a small enterprise's decision to formalise. In fact, formalisation can cost the same as not formalising – even when the cost of bribes incurred by informal workers is factored in. A recent survey conducted by DFID in Sierra Leone illustrates this problem very well.<sup>125</sup>

The World Bank and other multilateral agencies have promoted technical assistance projects aimed at helping tax administrations to improve their efficiency, transparency, accountability, and their ability to fight tax dodging and corruption. The standard prescription for tackling corruption has been to make tax authorities autonomous from ministries of finance and reduce arbitrariness. Some bilateral donors – particularly the UK, USA, and Australia – have prioritised technical assistance projects in this area with some success (such as in Rwanda with DFID's assistance). The aim has been to increase capacity for dealing with the management challenges of different taxes, depending on the fiscal policy adopted and needed in each context. Nevertheless there is still considerable scope for improving poor countries' collection capacity, reducing operating costs, and, above all, reducing the cost to those operating in the informal sector of entering the formal sector. Key to this is building capacity for dealing with the management challenges of different taxes, depending on the fiscal policy required and adopted in each context.

## Regional and local level taxation

Despite the widespread impetus to decentralise resources and decision-making, the quality of local fiscal policy remains a quagmire for many developing countries. In both Africa and Latin America, local taxes amount to only a very small proportion of total tax revenues. Ghana's regions generate only 16.5 per cent of local government income.<sup>126</sup> In Peru, small and medium-sized municipalities collect less than 8.1 per cent of their revenue; the remainder comes from transfers from central government and other income.<sup>127</sup> In Bolivia, locally-generated revenue accounts for 0.9 per cent of GDP and in Costa Rica for 1 per cent.<sup>128</sup> Likewise in Burkina Faso, Senegal, and the Côte d'Ivoire, local revenues represent less than 1 per cent of GDP. Almost all local revenues in these countries come from transfers from central government and/or from donors, or from shared national tax revenues.

The challenge of fiscal decentralisation is to find a balance between the advantages (for example, local governments being able to reach their citizens and ensure fiscal correspondence between those benefiting from public spending and the taxes they pay) and the disadvantages (for example, diseconomies of scale and constraints on combating inequality within countries).

Since regional governments may have more scope to address and respond to the different needs and preferences of their citizens or local groups, there is a case for their having a certain amount of fiscal autonomy. The challenge is to minimise a major source of internal conflict by reducing the gap between what someone pays in taxes and what they receive in return in public services.

Those who are less convinced of the benefits of fiscal decentralisation suggest that it can undermine government policies intended to reduce inequality between regions. Unfair tax competition may arise, both horizontally (between the regional authorities themselves) and vertically (between national and sub-national levels). Moreover, the efficiency gains from having a single, large, national tax collection in terms of economy of scale may be lost through fiscal decentralisation.<sup>129</sup>

Meanwhile, some evidence suggests that there is ample scope to improve the balance of fiscal decentralisation and specifically to increase the revenues generated for and collected by regional governments. Research also points to considerable room for improvement in realising the theoretical advantages of fiscal decentralisation. However, this is no simple task and not one that has received much attention from social movements.

There are two important issues affecting the prospects of achieving a good, local fiscal policy, besides the fact that local governments are increasingly responsible for providing basic social services. First, there is the question of the nature and amount of taxes or specific revenue sources that are determined and managed at the local level. Secondly, we have to take account of the rules governing the transfer of resources between national and regional levels, which can affect the policy of local income-generation. This in turn shapes the prospects of providing decent public services.

Local taxation is often inefficient and unfair. Despite the low collection rates, there are often several types of local tax. This may be a symptom of poor co-ordination between various tax systems at different levels of government or of flaws in the way that resources from the national level reach municipalities or communities. Failures in the processes of resource transfer from the national level may encourage local governors and mayors in pursuit of income to seek inefficient and unfair alternatives, such as levying a tax on access to basic education. According to a report compiled for the Tax Justice Network (TJN) on Ghana, arbitrary pressure on local governments to increase national income tends to give rise to the introduction of ineffective, capricious, and coercive taxes.<sup>130</sup>

TJN's report found that many people are often faced with at least two different uncoordinated tax systems. This damages the overall credibility of public resource collection systems and may encourage tax dodging.

#### **Box 9 Do so many local taxes make sense, given the low amounts collected?**

A recent study in Benin found a motley collection of tax and non-tax resources being levied to generate income in the country's municipalities:

- local service taxes: local development, territorial, buildings or land patents and licences, and firearms;
- local taxes: grazing, boats and motorised canoes, games and entertainment, the sale of home-made fermented beverages, advertising, billboards, and city taxis with two or four wheels;
- income from government rebates, covering the municipality's share: tourist tax levied by the state, motor vehicle tax, VAT collected at customs (0.4135 per cent rebate of the VAT collected at customs), sewer tax,<sup>131</sup> taxes on quarry exploitation and mining rights;
- income from remunerative taxes: market rights, rights on administrative acts, fines and rights on commercial services and income from wealth;
- revenue collected from administrative and civil registry office acts, income from fines related to the municipality, the rights to commercial services (parking fees, market rights, health services revenue, household waste collection tax), fees or taxes on urban planning and environment;
- income from assets, from the exploitation of local resources, from the sales of certain assets (forests, mines, quarries), and from the payments for services provided by the municipalities to their population;
- surcharges collected on electricity and water.

The diversity of local revenue sources when set against the small amount actually collected tells its own story. Public income from the collection of local taxes generates only 0.41 per cent of the country's GDP.

Source: Our compilation using Chambas, Brun, and Rota Graziosi (2007)

Although the national system generates the vast majority of local revenue, the tax system at the local level has a significant impact on the ordinary citizen.

Local governments rely on decisions and arrangements made at the national level for the transfer or reallocation of national taxes, such as VAT and personal income tax, down to the local level. The influence of national policies on local fiscal policy is therefore a key element in the funding of basic social services and the fight against poverty and inequality. At the very least, regional governments need to know how much money is to be transferred from the national budget to the local level, how resources are to be allocated, how much autonomy they have in the use of these resources, and how transparent the overall allocation process is. When this process is not transparent, there is a risk that measures to raise taxes at a regional level may further harm the already precarious situation of a poor and vulnerable population.

This need for transparency is greatest in countries dependent on extractive industries. Because natural resources are usually concentrated in certain areas of the country, a price boom may affect the geographical distribution of income. The concentration of both the potential benefits of natural resource exploitation and its costs for the local population and the environment in a few regions creates a breeding ground for tensions relating to public spending. This may affect the development and implementation of redistributive, compensatory, or sectoral policies and often provokes violent internal conflicts for control over natural resources.<sup>132</sup>

In Indonesia, the distribution of income from the extractive sector continues to generate high levels of inter-regional inequality. According to the World Bank, most of the income goes to just five out of 33 provinces. In Nigeria, only 40 per cent of the allocation of revenues from the extractive sector is based on population and on the social development level of individual states, which means that current mechanisms of income distribution mainly benefit the medium- and high-income regions. Regions with a larger population or higher poverty levels are not targeted. A study published by the Revenue Watch Institute (RWI), which analyses the distribution of extractive income (from royalties and special taxes) in Nigeria, Brazil, Bolivia, Indonesia, Mexico, Papua New Guinea, and Ghana, shows that in all these countries, the origin of the resources is taken into account when allocating at least part of the resulting income. Nevertheless, in all cases (with the exception of Mexico), local authorities in regions where the resources are extracted receive a larger proportion of natural resource income than non-producing regions, even when redistribution mechanisms are in place.<sup>133</sup>

## 5. The consequences of unfair tax systems

As this report has shown, the process of tax reform undertaken by a number of developing countries either contained significant omissions or failed to take into account context-specific variables. These shortcomings have affected not only the social outcomes of the reforms but also the expectations of greater revenues and greater tax system efficiency in general. Consequently, there is a case for a new wave of reforms.

It is difficult to judge whether the poor outcomes of previous reforms were due to advice not being followed properly; to countries adopting strategies to increase revenues in theory but then failing to implement measures with a high political cost; or to inherent flaws in the reforms and strategies proposed.

### Box 10 Earlier tax reforms: IFI omissions or developing countries' short cuts?

- **The tax base remains very narrow:** In many cases, authorities have focused on meeting the income goals set by international organisations through increased pressure on existing taxpayers rather than on expanding the numbers of taxpayers.<sup>134</sup> There is little evidence to support the prediction that there would be an increase in taxpayers as a result of reductions in nominal corporate and personal taxes. On the contrary, fiscal exemptions reduced the tax base. This means fewer taxpayers or the same number of taxpayers paying much less.
- **We will tackle distribution problems next time round:** The tax reforms undertaken in developing countries in recent years have focused on increasing revenues and on achieving efficiency improvements, while barely considering distribution at all. This is a major problem, not only because equity is a fundamental tax principle but because income distribution is very uneven in developing countries and is therefore crucial to achieving social legitimacy for the public sector.<sup>135</sup>
- **Excessive reliance on VAT:** Analyses of the economic crisis raise concerns about the IMF's desire to promote (potentially regressive) taxes on consumption as a condition for loans, while having no policies to tax the richest in other ways – through property taxes, for example. Some of the more successful developing country tax systems have relied, instead, on an important combination of both indirect and direct taxes, as demonstrated by Mongolia, Tajikistan, and Kyrgyzstan from 1995 to 1999 and from 2000 to 2006. Viet Nam, Ghana, and South Africa applied a similar combination.
- **Informal work markets are growing and there are no new proposals for their formalisation:** In effect, little or nothing has been resolved here. In fact, the size of the informal economy may be a key reason for the low levels of tax revenue attained in developing countries. No reform has addressed the diverse factors underlying the maintenance and growth of a sector which includes self-employed workers and workers in self-sustaining family enterprises on the one hand, and many medium-sized and large companies with unfair labour practices on the other. Measures taken to tax the informal economy or to impose regulation have often exacerbated poverty and vulnerability.
- **Remaining inefficiency:** Sub-Saharan Africa is possibly the most significant example. Despite the reforms, tax systems in many African countries are still characterised by too many taxes with too many legal loopholes, which both taxpayers and tax administrations find difficult to manage. These inefficiencies may reflect the excessive power of tax administrations and public officials when deciding on exemptions and the outcome of tax assessments.<sup>136</sup>
- **A partial view of fiscal policy:** In spite of improvements, there continue to be many flaws and gaps in the mechanisms designed to increase government incentives and capacities for achieving a sufficient level of pro-poor spending.

Source: Our compilation using various sources: McKinley and Kyrili (2009), Molina (2009), Third World Network, Garcimartín, Rodríguez and Gayo (2006), OECD (2010a)

This section focuses on the implications of unjust fiscal systems on poverty and inequality.

The meagre public budgets of developing countries are no accident and nor do they necessarily reflect low production potential or low tax collection potential. ActionAid affirms that if all developing countries were to raise their tax to GDP ratios to an average of 15 per cent, they could generate approximately \$198bn more a year – enough to meet their MDGs when combined with their ODA.<sup>137</sup> These figures are consistent with Oxfam's own estimates (see Section 7).

In fairness to some of the claims of the reforms that have been implemented, **efficiency measures can generate more income for a country and can, therefore, increase the potential for funding essential social policies.** However, the reforms have not always resulted in any significant increase in tax efficiency, while unfair taxation has fundamental implications in societies marked by gross inequality. A clearer understanding of the distributional effects of certain taxes, and of the determinants of such effects, may help shape more equitable tax systems without necessarily sacrificing efficiency.<sup>138</sup>

There is a degree of agreement that fiscal reforms have caused revenues to stagnate in developing countries and/or that they were not enough to achieve their potential. Given the characteristics of many developing countries (the size of the informal economy, the number of tax exemptions, the tax administrations' lack of technology, etc), the potential revenue anticipated from indirect taxes, such as VAT, may have been over-estimated. Nevertheless, premature reductions in international trade taxes have gone ahead in spite of the fact that these represented an important source of tax revenue for developing countries, as they still do in the case of sub-Saharan Africa.

The sudden drop in income from taxes on trade has further complicated matters for developing countries. Aside from the tax revenues that have been lost, the difference in the type of products exported by developing countries (labour-intensive) compared with developed countries (technology-intensive) has aggravated situation of the former. The removal of duties, for example, has meant that domestic industry in poor countries cannot be protected in such a way that would enable their capacity to export value-added goods to be gradually developed. The abrupt removal or reduction in trade taxes has also reinforced these countries' competitiveness based on low domestic wages. Such competitiveness attracts low-quality foreign investment, which seldom benefits countries or their populations.

**Tax policies have prioritised the goals of short-term revenue collection efficiency over equity and social justice. They have not addressed the challenge of collecting more from direct taxes, the foundation of progressive taxation systems.**

Fiscal policy is the key tool for achieving a better redistribution of wealth, for fulfilling economic opportunities, and for providing basic social services. As a rule, however, reforms have not fully exploited this potential. Proof of this can be found not only in the type of policies implemented, but in the lack of public debate in poor countries about the potential redistributive impact of the taxes adopted by the reforms. **Another indication is the lack of concrete proposals ensuring that the revenues collected are used for the benefit of the poor.**

Alongside the drastic reduction in direct taxes and taxes on international trade, greater efforts should have been made to ensure that public spending targeted the poorest sectors of the population more effectively. This targeting was all the more important in order to offset the overall losses in public income.

**A tax system not based on direct taxes is potentially less progressive.** Taxes in poor countries tend to be regressive or, at best, have no redistributive effect. Tax exemptions on goods and services used by the poorest can partly alleviate the regressive effect of

indirect taxes, but incentives, advantages, and exemptions have also been maintained for companies and for those people in the highest socio-economic strata, raising questions about the fairness of these tax systems.

**Some studies suggest that VAT has other harmful connotations for the poorest, such as a greater exposure to corruption.** The amount of VAT charged is based on the accounts of the trade conducted, but it is the poorest and smallest enterprises that find it the most difficult to keep such accounts, making them more susceptible to the corruption of tax collectors.

Moreover, as end-user agricultural goods are exempt from VAT (in order to prevent price increases for poor consumers) but inputs such as fertiliser are not, an unlucky producer who endures a poor harvest may not be able to recover the expenses incurred in growing their crops, including any VAT payable on inputs. The lack of insurance against such incidents as poor harvests for the most vulnerable people in the poorest countries makes such hazards even greater.

Besides the plethora of tax incentives in developing countries, **non-wage personal income is barely taxed at all and property taxes are used minimally and are poorly implemented.** Wrongly applied personal income tax or corporate tax can be as regressive as a tax on consumption. For instance, if a company is taxed but has a lot of scope to transfer the tax cost to the final price of the product, the measure's progressive effect may be cancelled out. This is common in monopoly or oligopoly markets – precisely those that are most common in developing countries.<sup>139</sup>

The more mobile nature of capital compared to land or labour allows the owner of the capital to evade tax obligations more easily. Moreover, the richer echelons of society, who are usually better connected politically and more articulate than the rest of society (especially in the most unequal societies), are better placed to apply political pressure and block more progressive tax systems.<sup>140</sup> Paradoxically, an analysis by the IMF in 2007 showed that civil servants in developing countries (many of them on meagre salaries) are the least likely to escape paying taxes, since they are part of the public system.<sup>141</sup> **In terms of personal income, tax pressure usually falls on a few – the wage earners – making the fiscal systems of developing countries less equitable.** If government revenue is based on taxing consumption by means of taxes such as VAT and there are no appropriate mechanisms for saving, then spending will become pro-cyclical: more spending in boom times and less spending in times of economic downturn, just when more relief measures for the most vulnerable are needed (as was the normal process in most Latin American countries in the past). Tax systems based on direct taxes are less prone to this behaviour because the effects of the economic recession on aggregate income are less immediate.<sup>142</sup> This is due to automatic stabilisers such as unemployment protection, among other factors.

Digging deeper into the potentially regressive aspect of taxes on consumption, it is worth highlighting certain publications recommended by UNIFEM (United Nations Development Fund for Women),<sup>143</sup> which explore how different forms of taxation and the complexity of tax systems in many developing countries can result in a gender bias at the expense of women. For example, consumption taxes may have a bias towards poor women over men since women spend a larger proportion of their incomes on consumer goods for their families.

### Box 11 VAT and gender bias

A gender impact analysis of VAT on small and medium-sized enterprises (SMEs) in Viet Nam revealed that this tax penalised women owners of SMEs. The study showed that the low income and low profitability of SMEs owned by women, compared with the income and level of profitability of SMEs owned by men, can be explained by the differences in the structure of costs and expenses for each group.

Women SME owners had less access to cheap credit and were more reliant on credit from informal sources, which were usually more expensive. As a result, there was an over-estimation inherent in the added value on which their taxes were levied.<sup>144</sup>

Furthermore, SMEs owned by women were less likely to be formally registered and were therefore less likely to be able to make deductions for productive inputs, which are often expensive due to the normally small scale of production and/or sales.

In addition, the intensive sector for female SMEs – commerce – tended to be taxed at a higher rate than production – the SME sector where male owners predominate.

Although female entrepreneurs were more likely to meet the criteria for exemption from payment of VAT, they were less likely to benefit from any exemption, as many of their enterprises were not formally registered.

The study indicated that the bias of VAT against women entrepreneurs increased their costs and resulted in less revenue. The report argued that women did not work in activities where profits were lower; on the contrary, they dominated the commercial sector, which has, in principle, high expectations of profit. Women worked in occupations in which gender bias increased their cost structures, hence, 'the main explanatory variable is not the activity, but the gender.'

Source: Akram-Lodhi and van Staveren (2003)

**When a tax system is based on indirect taxes, people are less aware of taxpayer rights and duties than when they are taxed individually.** Taxpayer effort is much easier to see in the payment of direct taxes than in indirect taxes where the share allocated to the state is implicit in the price of goods and services and the taxpayer only perceives its presence when there are specific tax hikes. With indirect taxation, there is less public sensitivity about the proper use of their taxes and less public demand for the appropriate and accountable use of money contributed to the common good, namely the state.

**In a country where taxation is fair, the underground or grey economy cannot carry on without state representation.** Conversely, the informal sector is a symptom of a lack of confidence in a public system and those who work in it have less of a stake in pressuring the tax system or other public authorities to comply with their duties. The low quality of the public system is an obstacle to reducing poverty and inequality.

Finally, in many developing countries, potentially low redistributive capacity through taxation often goes hand in hand with a low redistributive capacity through spending, since very few funds are available and there are competing spending priorities.

## 6. Sustainable public finance and integrated societies: experiences and opportunities

This report has shown the importance of a good tax system in reducing poverty and fighting inequality, as well as the need for policies that promote social inclusion and more integrated societies. **Crucially, socially-inclusive development in poor countries depends on identifying the right mixture of revenue sources and suitable tax and spending policies that will result in the redistribution of wealth.**

**Clearly there is a correlation between taxation on the one hand and the process of strengthening a government's capacity and regulatory framework on the other. Indeed, the process by which the state obtains its revenue is closely linked to the concepts of governance (the rules of the game) and governability (the capacity to carry out public policies).** For example, if a country gets its revenue from development aid or from exports of natural resources, sooner or later this trend will have a bearing on the capacity of the country's institutions and the management of its resources, both material and human.

It is worth exploring the potential impact of fiscal systems on development and on reducing poverty and inequality both from a theoretical perspective and also in practice. Below we highlight experiences in Malaysia (Box 12), Ghana (Box 13), and South Africa (Box 14) where attempts have been made to implement fairer tax systems, either through redistribution policies, or through policies that positively discriminate in favour of particular sections of the population, promote formalisation of the informal economy, or reform of the management of public finances.

### Tax systems, poverty, and inequality

A **comprehensive tax policy** is possibly the most obvious tool that governments can use to fight inequality. Vertical inequality occurs among individuals or households and is measured in terms of income, assets, or wealth. Horizontal inequality relates to whole sections of the population and derives from membership of specific ethnic or religious groups.

Identifying the nature and degree of vertical inequality is important because:

- one needs to know how much scope there is for creating a fair society;
- the degree of inequality for any given level of per capita income will determine the level of poverty;
- there is evidence that fairer societies grow faster;<sup>145</sup>
- greater inequality is associated with high crime rates.<sup>146</sup>

Measuring horizontal inequality involves a wide range of political, economic, and social variables.<sup>147</sup> It is especially important to identify these in conflict-prone societies where evidence suggests the nature and degree of such inequality is often a decisive factor behind the risk of violence. Violent conflicts undermine development and increase poverty levels,<sup>148</sup> and violence is often associated with fragile states that are unable to manage their development processes.

The challenge of creating more integrated societies in developing countries, based on a better horizontal and vertical distribution of income, wealth, and economic opportunities, remains substantial.<sup>149</sup>

In Annex 2 we can see that in Namibia and Bolivia the income of the richest 10 per cent of the population is around 100 times the income of the poorest 10 per cent. In Guatemala

only 9 per cent of the quintile (20 per cent) of the population with the least resources has access to medical specialists, as opposed to 92 per cent of the quintile of the population with the highest income. In developed countries, specialist medical attention is almost universally available.

The growth of a country's economy does not necessarily lead to a reduction in inequality. In fact, empirical evidence and various economic theories affirm that strong growth initially provokes an increase in inequalities.<sup>150</sup>

According to Kuznet, this tendency reverses automatically in the medium term due to the redistributive actions of the government and to the fact that dynamic economies create an atmosphere of relative freedom which favour individual liberties and offer the new industries faster growth which then enlarges the middle class. Kuznet suggests that these economies are characterised by a growing tendency to shift the workforce from low to high revenue industries.<sup>151</sup>

However, the assumption that inequalities will diminish in the medium term does not have much empirical support.<sup>152</sup> Some authors point out that governments do not necessarily take the kind of redistributive action that will be sufficient to counteract the tendency towards a growth in inequality. In fact, **the trend towards inequality can be reversed but only if appropriate redistributive policies are undertaken during the stages of economic growth. In other words, reversing the trend towards greater inequality is not automatic.**<sup>153</sup>

Unless there is a shift in the focus of public policy towards the most vulnerable sections of society, more public resources will continue to flow to those sections that least need them, thereby bolstering internal structures that perpetuate inequalities and keep the poor in poverty. What is needed is greater investment in basic social services targeted at those sections of the population suffering from systematic discrimination, together with policies that will generate employment for these people. Economic opportunities are inherently associated with the capacity of individuals to take advantage of them.

**Effective fiscal policies can drive changes that will reduce inequalities**, as some investigations have shown. For example, horizontal inequalities can be addressed by **adapting taxes to the behaviour of different population groups in which a positive impact is sought, altering the regional balance of taxes and income, and increasing the amount of tax collection channelled into spending that will potentially reduce such inequalities, i.e. spending on basic social services.**<sup>154</sup>

The case of Malaysia clearly demonstrates the potential of tax policies for correcting inequalities – in spite of the problems encountered in implementing these policies. These problems included clientelism and corruption, and possible discrimination against the Chinese population. It is worth noting that the data regarding the impact of Malaysian tax policies is of a low quality and that assessing the effectiveness of poverty reduction policies in an environment of economic growth can be difficult (see Box 12).

### Box 12 Comprehensive fiscal policy in Malaysia

Malaysia has implemented comprehensive measures, fiscal and non-fiscal, to tackle horizontal inequalities that negatively affect the country's ethnic groups, particularly the inequalities between the *bumiputeras* (a term that includes Malays and other indigenous groups) and the Chinese.<sup>155</sup>

Between 1970 and 1990, Malaysia's tax policy was established within the framework of the New Economic Policy (NEP), initially as a response to riots provoked by the general elections in 1969. The NEP had two main purposes: 'the eradication of poverty', regardless of ethnic origin, and 'the restructuring of society' in order to eliminate the association between race and economic function within Malaysian society.

The NEP was underpinned by the first Outline Perspective Plan [OPP] for 1971–1990, which sought to reduce poverty from 49 per cent in Peninsular Malaysia [sic] in 1970 to 16 per cent in 1990.<sup>156</sup> Although

there are doubts about the reliability of the Malaysian government's data, it is likely that poverty fell significantly in the 20 years of the NEP. In 1990, the actual poverty rate in the peninsula was estimated at 17 per cent, while the national rate was slightly higher.<sup>157</sup> In 1970, 65 per cent of *bumiputeras*, 26 per cent of ethnic Chinese, and 39 per cent ethnic Indians were poor. By 1990 these figures were 20.8 per cent, 5.7 per cent, and 8 per cent respectively.<sup>158</sup>

The NEP's main target was to increase the *bumiputera* share of corporate stock ownership from 1.5 per cent in 1969 to 30 per cent in 1990. The government's data suggests that ownership among *bumiputeras* rose to about 18 per cent in 1990 and to slightly over 20 per cent in 2000.<sup>159</sup>

During the NEP period, Malaysia enjoyed very high average economic growth rates and a significant reduction in horizontal inequality. In 1970, in Peninsular Malaysia, the monthly income of a Chinese household was 2.29 times that of a *bumiputera* household. By 1990, this ratio fell to 1.74 times.<sup>160</sup>

Following the NEP, the National Development Policy (1991–2000) and the current National Vision Policy (2001–2010) have maintained the broad objectives of the NEP, although enthusiasm for redistribution has been somewhat reduced.<sup>161</sup>

Here are some relevant strategies in the context of the NEP:

### **Strategy I: Reinforcing a progressive tax system**

The country's fiscal revenue to GDP grew during the period of the NEP from a little over 15 per cent to about 20 per cent. The Malaysian tax system was already progressive when the NEP began (the Chinese contributed proportionately more to total tax revenues).

As a result of the improvement in their economic status, *bumiputeras* contributed a higher proportion of overall tax revenues.<sup>162</sup> However, within the framework of the NEP, some favourable tax reforms were introduced for this group.

A reduction in export taxes probably reduced the burden on the *bumiputeras*, due to the significant presence of Malays in business activities orientated towards exports. Increased tax rates on alcohol have probably been borne by 'non-*bumiputeras*' because of the Muslim prescription against drinking alcohol. In addition, a tax on trade with China was introduced, a measure that may have affected local Chinese businesses rather than *bumiputeras*.<sup>163</sup>

### **Strategy II: Spending and employment policies**

The NEP's restructuring strategy mainly involved the redistribution of corporate stock ownership, employment and education, with the latter two sometimes considered together.

Under the NEP, government contracts and licences were awarded to individuals from the *bumiputeras* group, as well as *bumiputera*-owned companies.<sup>164</sup> Almost all small contracts were reserved for this group.

Government policy within the framework of the NEP particularly favoured the recruitment of Malays as civil servants. In 1970, Malays accounted for barely 40 per cent of civil servants in Division I (the highest level). By 1987, this figure had risen to 65 per cent. In 1999, *bumiputeras* made up 76.9 per cent of the public sector workforce, including 9 per cent of its managers.<sup>165</sup>

Public policies also affected private sector employment, as public contracts to companies that did not support the policy of employment in favour of *bumiputeras* were restricted.

Education was the area where the policy of redistribution was most noticeable. A quota system for students entering university led to a significant increase in the participation of *bumiputeras* in local tertiary education from 40 per cent in 1970 to 63 per cent in 1985. Between 1980 and 1984, over 95 per cent of successful applicants for scholarships to study abroad were *bumiputeras*.<sup>166</sup> By 1995, *bumiputera* students made up 73 per cent of those registered in public tertiary education institutions.<sup>167</sup>

Although this strategy has had some success, there is no doubt that corruption and clientelism have tainted some of the potentially positive effects of the NEP. The impact of the assignment of governmental contracts may have been weakened by 'Ali-Baba' dealings, in which an 'Ali' (a common name in Malay) with good political contacts provided the face of a *bumiputera* on behalf of a businessman 'Baba' (a common term for the Chinese). In reality, the *bumiputera* partner usually continued to be nothing more than a silent partner.

Other criticisms made of the NEP were the waste of resources and the extent of the pro-poor orientation of many policies. Some people also believe that the redistributive policy has deepened ethnic intolerance: 'Most older Malaysians seem to think that interethnic relations deteriorated in the 1970s and 1980s, and many were inclined to attribute this – at least partly – to the implementation of the NEP.'<sup>168</sup>

Sources: Our compilation using various sources: Bahrawi (2009), Stewart, Brown and Cobham (2008), Pérez and Sierra (2004), Jomo (2004), Rasiah and Shari (2001)

Ghana has taken an unconventional step towards formalisation of the informal economy, a vital ingredient in the move towards a fairer tax system (see Box 13 Ghana: opportunities for a win-win situation in the informal sector?):

There are no figures available, but there is evidence of a growing number of unions organising workers in informal employment ... In Africa, the Ghana Trade Union Congress (GTUC) was one of the first formal trade union federations to recognise a need and responsibility to organise informally employed workers and to begin to successfully implement its resolution. In 1995, the Zambia Congress of Trade Unions (ZCTU) amended its constitution to allow for affiliation of informal economy associations (...) The Alliance for Zambia Informal Economy Associations (AZIEA) was launched in 2002 and is an associate member of the ZCTU...<sup>169</sup>

The Programme for the Reinforcement of Trade Union Action in the Informal Economy (PRASEI) (involving national unions, the ILO, and DANIDA [Danish International Development Agency]) has set up a mutual provident fund known as MUPRESSI, which is open to all informal economy workers. PRASEI has also created conditions for improved informal worker representation in the State.<sup>170</sup>

### **Box 13 Ghana: opportunities for a win-win situation in the informal sector?**

Although there is a long tradition of activism in the transport and market trader sectors in Ghana, it was in the period of the Rawling Revolution (1981-85), when the PNDC (Provisional National Defence Council) party was in power, that the informal sector became much more organised. The Ghanaian Private Road Transport Union (GPRTU) which represented vehicle owners and operators had a particularly strong political influence.<sup>171</sup>

In 1983, a fiscal crisis prompted a series of tax reforms, including the creation of two offices to collect taxes: the Internal Revenue Service (IRS) and the Customs, Excise and Preventive Service (CEPS). The main aims of the reform were to:

- facilitate collection;
- decentralise operations and improve taxpayer identification;
- develop new policies to improve tax collection in the informal sector.<sup>172</sup>

In 1986, the government carried out a consultation process with the GPRTU through the IRS to improve tax collection from informal hauliers. The GPRTU's input was a key component in the improvement of the system as it pointed out problems with the previous systems.

The most common method of taxing the informal sector is by presumptive taxation: estimated taxes based on certain assumptions, such as size and situation, and generally paid once a year.<sup>173</sup> The GPRTU pointed out how inappropriate it was for this tax to be paid yearly or quarterly, when hauliers generate income daily. In addition, presumptive taxation took no account of working days lost due to vehicle breakdowns or driver illness. The consultation also highlighted complaints about corruption in the vehicle licensing office that issued the certificates required for the payment of taxes and about the fact that the tax payment process involved waiting in the tax collection office for a whole day. These factors made the administration, collection, and application of taxes very problematic.<sup>174</sup>

In 1987, the government introduced a new group occupational identification system for taxation purposes, starting with the transport sector and then extending it to more than 30 other sectors. The new method also assumed presumptive taxation, but tax collection was decentralised and carried out by industry associations, allowing daily or weekly payments.<sup>175</sup>

Since 2000, there have been some adjustments to the system, prompted by allegations about inefficient arrival of public resources channelled through the GPRTU or the possible opportunism of some big companies dodging taxes. GPRTU has also been criticised for serving the interests of company owners more than the individual vehicle operators.<sup>176</sup>

Nevertheless, these policies have laid the foundations for levying taxes on the informal sector in Ghana, and, although tax revenues from the informal sector do not contribute all that much to the government coffers, they grew more than fivefold between 2005 and 2008.<sup>177</sup>

Sources: Our compilation using various sources: Prichard (2009), Joshi and Ayee (2008)

## Fiscal systems and good governance

The nature of the revenues upon which a country depends can shape its institutions and the way the public sector interacts with its development. A sudden influx of revenue from the sale of oil and minerals, for example, can be difficult to absorb and administer in countries that rely on extractive industries.<sup>178</sup> If a country's main source of revenue is aid and that aid is channelled into a series of separate projects disconnected from a coherent national development plan, it can weaken national institutions and encourage the fragmentation of resources.

In both situations, the government has no incentive to foster productive relationships with most of its citizens, since it does not look to them for the lion's share of its income. Its accountability is to international corporations in the case of extractive industries or to donors in the case of aid.

In contrast, revenues from taxation can increase public participation in decision-making about how public resources are used, creating greater public demand for accountability, and greater efficiency in the use of public money. Oxfam's research in Azerbaijan found that, where citizens can see their money going into a system they trust and being transformed into services they need, their demand for accountability increases and their tendency to try and dodge taxes lessens.<sup>179</sup> For the population to perceive progress, a higher tax burden must therefore go hand in hand with higher social spending.

The efficiency of social spending is clearly related to the quality of fiscal institutions. If a mix of taxes can increase the volume and reliability of domestic resources, the scope for making longer-term public spending policies is also increased.

### Box 14 South Africa: taxation and good governance

The example of South Africa is particularly pertinent because its economy has historically depended on the extractive industries, above all mining. Countries that rely on revenue from extractive industries face many challenges when trying to manage those resources in a manner consistent with sustainable and inclusive development. The extractives sector has enormous potential to generate revenue, but the complex social, economic, environmental, and political implications can hamper development processes.<sup>180</sup>

On a positive note, South African fiscal revenues have increased since 2000 (from 23.2 per cent to 27.8 per cent), thanks to an increase in both VAT revenues (up 16 per cent) and tax revenues from companies (up 3.7 per cent).

The increase in tax collection seems to have been part of a broader strategy that included a re-orientation of the country's development model in order to reduce dependence on extractive industries and important improvements in the management of public finances.<sup>181</sup>

Income from mining activity is taxed under the Income Tax Act (1997).<sup>182</sup> In order to reduce the likelihood of murky negotiation processes with mining companies and the scope for ministerial arbitrariness in granting tax deductions and exemptions, the mining tax rate is not fixed individually per mine. All decisions come from the Ministry of Finance and are approved by Parliament.<sup>183</sup> This contrasts with the general opacity of commercial negotiations between private international companies and the governments of developing countries that depend on extractive industries.<sup>184</sup>

Another key issue for good governance in countries that depend on the extractive sector is transparency in the transfer of resources between national and regional governments.

South Africa has tried to tackle this problem with some interesting initiatives. For example, Section 77 of the Constitution (which is consistent with Article 5 of the Public Finance Management Act, No. 1 of 1999) established that the National Treasury, directed by the Ministry of Finance, could authorise 'money-bills', which can: confiscate money; introduce taxes or duties; cancel, reduce, or grant tax exemptions; or authorise direct charges to the National Revenue Fund. Strict parliamentary procedures must be followed to approve such a bill.

The South African Constitution (section 214) stipulates that an Act of Parliament (such as the annual budget) must plan for the equitable division of all revenues among the national, provincial, and local governments. The equitable division of income throughout all levels of government can be enacted only

after provincial governments, organised local governments, and the Fiscal Commission have been consulted and any recommendations from the Commission has been taken into consideration.

Sources: Grote (2008), SARW, TWN Africa, Tax Justice Network Africa, ActionAid, and Christian Aid (2009), Oxfam (2009).

## Opportunities: the role of international co-operation

**In the long term, fair and appropriate taxation represents a key step towards guaranteeing sustainable sources of finance for development. As mentioned above, it can also reinforce the contract between citizens and the state. For these reasons, aid can promote the construction and good performance of fair tax systems.**

Specifically, aid could:

- complement, rather than substitute, domestic resources, thereby supporting counter-cyclical public spending policies;<sup>185</sup>
- be channelled through the state budget, as this can enhance the management of public finance<sup>186</sup> and broaden the tax base (through the payment of salaries to more health and education professionals, for example);
- have a multiplying effect on productivity and growth, thereby increasing the tax base and improving conditions for investment.<sup>187</sup>

In general, donors could:

- support governments in the construction of more efficient and effective tax collection systems and in the design of new systems and incentives for attracting those operating in the underground economy into the formal sector;
- support reforms relating to transparency in the handling of public finances at all levels of government, pushing for systems that offer as much information as possible on public finances and the use of public money;
- support the work of local organisations to monitor public spending. Even the best designed tax reform will fail if the revenue from tax is not used to address the needs of the most vulnerable sectors of the population, or if there is a lack of fiscal discipline on the part of the government. Civil society therefore has a critical role to play in ensuring social investments are not compromised;
- encourage appropriate spending levels (for example, in health and education) and support long-term development goals, such as greater social protection for small-scale farmers and the promotion and development of domestic industry and employment.

### Box 15 A very long-term aid program in Mali

In Mali, the Canadian International Development Agency (CIDA) works with tax authorities to improve the functioning of the country's fiscal system. Between 1997 and 2005, this work included employee training and skills building. Thanks in part to the CIDA-funded programme, the amount collected in taxes rose from \$368.15m to \$851.04m, thus more than doubling the taxes collected over the eight-year period.

Source: Oxfam (2010)

## 7. Increasing domestic resources: how far can we go?

### Revenue potential

This section makes an approximate estimate of the increase in revenues that some developing countries could obtain if they increased their current tax to GDP ratios.

This could be achieved by

- formalising parts of the informal economy;
- reducing tax dodging through the prevention of illicit capital flight to tax havens;
- reducing the tax expenditure resulting from the abundance of exemptions unconnected to social goals;
- raising direct taxes, especially taxes on non-wage incomes.

Below we explore some possible scenarios for improvement in tax to GDP ratios, based on measures and reforms already referred to. Each is examined from two different perspectives, one more ambitious (A) and one more moderate (B). It is important to bear in mind that this is only an analysis of tax collection potential in the countries from which data was obtained. Data was not available for some of the more fragile states which tend to be less well-placed to increase tax revenues. The effect on the estimates of the possible non-inclusion of some of the more fragile states therefore has to be considered.

Accordingly, the amount corresponding to fragile states has been subtracted from the estimated total increase in collection for the countries analysed, as undertaking fiscal reform in these settings is complicated.

The analysis is static in that it does not take into account the effects of proposed measures on the economy in the short and medium term. It does not analyse negative effects, such as a possible withdrawal of investment, consumption, and/or savings as a consequence of possible tax increases, or the positive effects of increases in public expenditure and investment as a result of higher revenues.

#### *Formalising part of the informal economy*

The first scenario (Formalisation, Table 4) estimates the increase in tax collection that could be obtained by acting on the informal and underground economy, incorporating part of it into the formal economy. Achieving this may be difficult but it is made all the more important by the fact that the informal economy has expanded, largely as a result of barriers to entering the formal sector (e.g. high transaction costs, failures in credit markets, dysfunctional labour markets for the poorest, and irresponsible labour practices). In this scenario, the possibility of reducing the informal or underground economy has been examined for each country analysed, assigning each country to one of the following three groups:

- **Group I: countries with high potential**
- **Group II: countries with medium potential**
- **Group III: countries with low potential**

The basic criterion for placing a country into groups I, II, or III was the initial percentage of its underground economy in relation to its GDP (the bigger the percentage, the greater the tax collection potential in this area). We have also taken into account the percentage of informal employment in relation to total non-agricultural employment, as this may be

the part of the informal or underground economy that could be most reduced through social inclusion policies.

Under the more ambitious Option A, the informal or underground economy would be reduced (as percent of GDP) by

- 15 per cent in Group I
- 8 per cent in Group II
- 2 per cent in Group III

Under the more moderate Option B, the informal or underground economy would be reduced by

- 7.5 per cent in Group I
- 4 per cent in Group II
- 1 per cent in Group III

**Table 4 Tax revenue potential through formalisation (various countries)**

Country/region	Underground economy (% GDP) (1)	Size of informal employment as % of total non-agricultural employment (2)	Tax revenue (% GDP) (3)	Tax collection potential in Option A (\$m) (4)	Tax collection potential in Option B (\$m) (4)
<b>Latin America</b>					
<b>Group I (high potential)</b>					
Bolivia	67.3	63.5	19	475.2	237.6
El Salvador	46.4	56.6	13	431.2	215.6
Guatemala	51.5	56.1	11.3	660.7	330.4
Honduras	49.5	58.2	14.7	294.2	147.1
Nicaragua	45.3	N.A.	17.6	174	87
Panama	64.3	49.4	10.8	374	187
Peru**	60.1	67.9	15.6	3,021.1	1,510.5
<b>Group II (medium potential)</b>					
Argentina**	25.5	53.3	13.7	3,599.9	1,800.0
Brazil**	39.8	51.1	26.7	33,645.2	16,822.6
Colombia	39.4	38.4	13.5	2,632.6	1,316.3
Costa Rica	26.2	44.3	15.3	363.1	181.5
Ecuador**	34.2	74.9	12.5	546.8	273.4
Mexico	30.4	50.1	9.01	7,843.2	3,921.6
Paraguay**	27.8	65.5	12.4	158.5	79.2
Dominican Republic	32.2	47.6	14.9	542.8	271.4
Uruguay	35.2	N.A.	17.1	440.3	220.2
Venezuela, (Bolivarian Republic of)**	30.8	49.4	13.5	3,392.8	1696.4
<b>Group III (low potential)</b>					
Chile**	19.9	35.8	19.5	660.9	330.4
<b>GDP weighted average</b>	<b>34.0</b>		<b>18</b>	<b>58,596.1</b>	<b>29,298.1</b>
<b>Africa</b>					
<b>Group I (high potential)</b>					

Benin	48.3	92.9	17.2	172.4	86.2
Congo, Republic *	48.3	59.6	6,1	107,8	53,9
Nigeria**	76.0	N.A.	5.9	1,833.0	916.5
Tanzania	58,5	N.A.	14,8	454,9	227,4
<b>Group II (medium potential)</b>					
Algeria**	34.6	41.3	8	1,065.9	532.9
Botswana**	33.4	N.A.	30.2	324.1	162.0
Burkina Faso	41.1	77	12.1	76.9	38.5
Burundi	25.7	N.A.	18	16.7	8.4
Cameroon**	32.8	N.A.	18.5	346.3	173.1
Chad*	46.7	95.2	5.3	35,6	17.8
Egypt**	35.0	45.9	15.4	1,999.3	999.7
Ghana**	42.1	N.A.	20.6	274.4	137.2
Guinea*	40.9	86.7	14.7	44.7	22.3
Kenya**	34.2	71.6	20.9	507.5	253.8
Madagascar	39.9	N.A.	12.9	97.7	48.8
Mali**	42.4	81.8	15	104.9	52.4
Mauritania**	36.5	80	13.4	30.6	15.3
Mauritius	25.8	N.A.	19	141.7	70.8
Morocco	36.6	67.1	26.9	1,912.8	956.4
Mozambique**	40.4	73.5	14.2	111.8	55.9
Namibia**	32.0	N.A.	24.8	175.3	87.7
Niger*	42.3	62.9	11.4	48.8	24.4
Senegal	33.0	76	18.3	194.3	97.2
South Africa	28.5	50.6	25.7	5,683.7	2,841.9
Tunisia	38.7	35	22.4	722.3	361.2
<b>Group III (low potential)</b>					
Zambia**	14.7	58.3	17.5	50.1	25.0
<b>GDP weighted average</b>	<b>27.0</b>		<b>17</b>	<b>16,425.9</b>	<b>8,212.9</b>
<b>Asia</b>					
<b>Group I (high potential)</b>					
Thailand	71.0	51.5	16.5	6,742.6	3,371.3
<b>Group II (medium potential)</b>					
Bangladesh	35.3	N.A.	8.8	560.1	280.0
India	23.7	83.4	12.9	11,962.6	5,981.3
Malaysia	30.9	N.A.	17.58	3,119.0	1,559.5
Philippines	43.9	72	14.1	1,882.7	941.4
Sri Lanka	44.6	N.A.	14.2	460.8	230.4
<b>group III (low potential)</b>					
Indonesia	19.1	77.9	11	1,123.6	561.8
Viet Nam	15.7	N.A.	13.8	250.2	125.1
<b>GDP weighted average</b>	<b>23.0</b>		<b>13</b>	<b>26,101.7</b>	<b>13,050.8</b>
				<b>Tax collection potential A</b>	<b>Tax collection potential B</b>
		<b>Total</b>		<b>101,123.7</b>	<b>50,561,9</b>
		<b>*Fragile countries</b>		<b>129.23</b>	<b>64.61</b>
		<b>Without fragile countries</b>		<b>100,994.5</b>	<b>50,497.2</b>

Sources: Our compilation using various sources. Charmes (2000), Schneider (2000), Schneider and Buehn (2009), Schneider and Enste (2000), World Bank Tax Revenue, ECLAC, OECD African Development Bank (2010)<sup>188</sup> (accessed December 2010)

(1) Indicates the underground economy as an estimated percentage of GDP according to Schneider and Buehn (2009)<sup>189</sup>

(2) Indicates the percentage of undeclared employment out of the total. The estimate comes from the OECD

(3) Data on revenue collection as a percentage of GDP: African countries: *African Economic Outlook* with data from the OECD; American countries: ECLAC; Asian countries: World Bank.

(4) The potential informal economy that could be formalised as a percentage of GDP multiplied by the tax burden or collection as a percentage of GDP (third column in the table).

(5) \*\*Countries with export potential (extractive or agricultural industries)

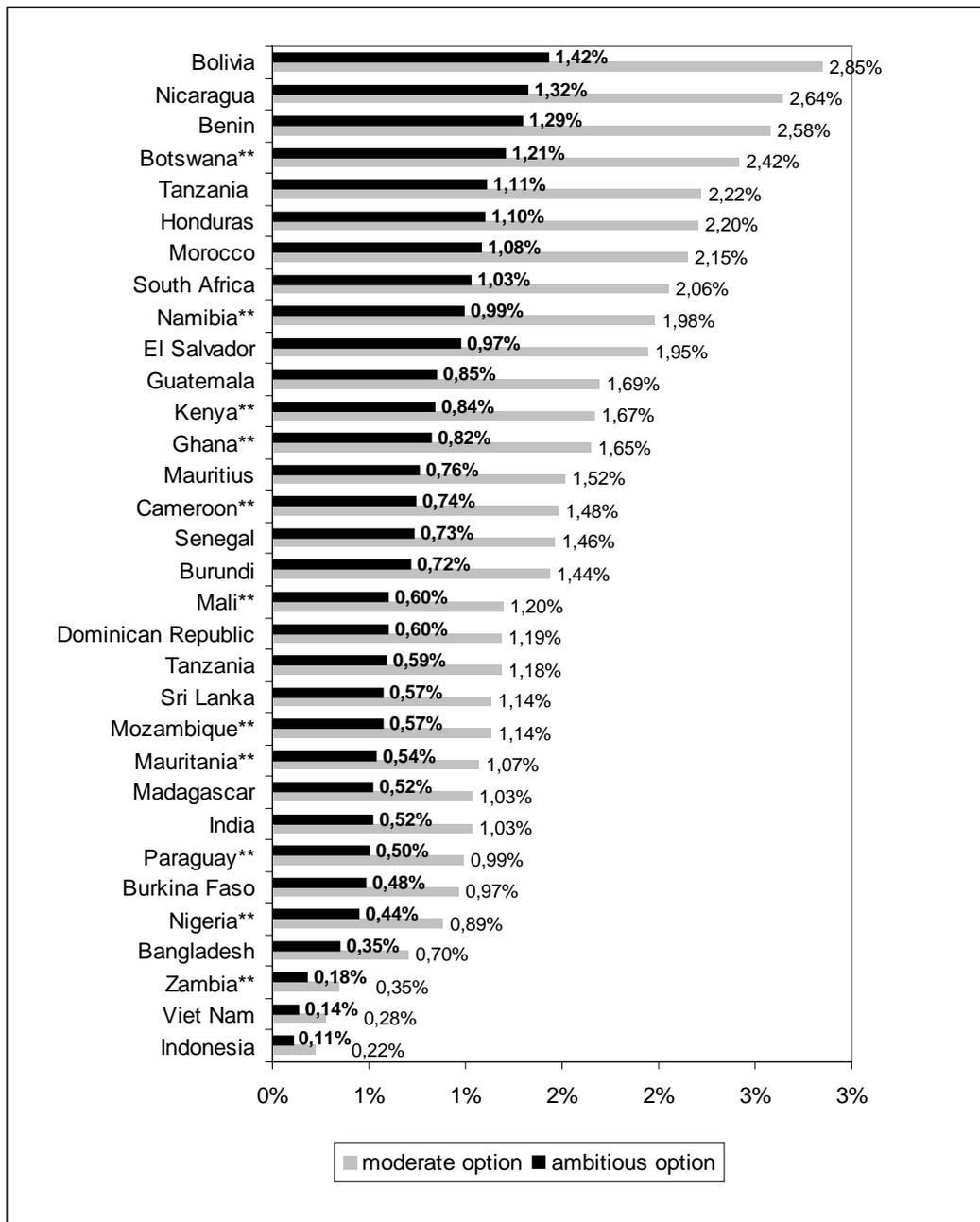
The calculations in Table 4 show that additional revenue of over **\$101bn per year could be generated through the more ambitious Option A (or \$50.5bn through the more modest Option B )**, simply by intervening in the group of countries analysed. See Annex 3 for more details of these calculations.

Table 4 illustrates that the percentage of the informal economy in relation to GDP in the low and medium-potential countries is very high: more than 45 per cent in Group I countries and 23 – 45 per cent in Group II. By contrast, the informal economy average in OECD countries is around 15 per cent of GDP.<sup>190</sup> Moreover, the tax to GDP ratio in OECD countries is also much higher,<sup>191</sup> while the percentage of informal employment in relation to total non-agricultural employment is noticeably lower.<sup>192</sup> All efforts should therefore be made to tackle this problem in developing countries. However, as has been reiterated throughout this report, the formalisation of the informal economy and the provision of decent jobs are the keys to improving the conditions of people living in poverty and vulnerable situations.

Under this scenario, it is envisaged that formalisation would result in both an increase in GDP and in additional revenue – via taxes – from the new taxpayers incorporated into the formal economy, without causing a reduction in the overall tax to GDP ratio. To avoid such a reduction, the tax burden or fiscal pressure must be intensified in other sectors, because the new taxpayers – most of them from lower socio-economic levels – will not be able to pay the same rate of tax as the national average.

Figure 8 shows that a broad range of countries with an average medium or low HDI could potentially benefit from such reforms. It is also interesting to note that countries with a pressing need for development finance such as Bolivia, Nicaragua, and Benin rank highly, amongst those that could benefit.

**Figure 8 Tax revenue potential (% of GDP) through formalisation (various countries)**



Sources: Our compilation based on our calculations (Table 4) and UNDP (2010)

\*\*Countries with export potential (extractive or agricultural industries)

### ***Increasing the tax to GDP ratio***

The second scenario (see Table 5) estimates a possible improvement in tax collection by raising the tax to GDP ratio or general fiscal pressure.

We do not analyse *how* each country should increase this pressure, as the methods adopted must be appropriate to each nation's circumstances. Nevertheless, **we recommend targeting the direct taxation of non-wage income and curbing the exemptions enjoyed by companies and individuals with greater economic power. Such reforms would provide the fiscal system with more equity and progressiveness than if**

**tax collection improvements were focused solely on increasing indirect taxes.** The collection of direct taxes is very low in developing countries compared to developed countries, particularly the collection of taxes levied on non-wage income, which means there is considerable potential for increasing revenues in this area.

To calculate the prospects of improvement through this scenario, each country's possible increase has been classified in relation to one of the following groups:

- Group I: countries with high potential
- Group II: countries with medium potential
- Group III: countries with low potential
- Group IV: countries with very low potential.

The criteria for assigning the countries to different groups are as follows:

- per capita GDP
- current tax to GDP ratio
- the extent of the economy's dependence on extractive or agro-exporting industries (although positive for tax collection potential, such dependence in the medium term is not sustainable).

If a country had a per capita GDP that was greater than its tax to GDP ratio (e.g. high per capita GDP but a medium or low tax to GDP ratio), it was classified in Group I.

If the two figures were similar (e.g. medium per capita GDP and a medium tax to GDP ratio), it was placed in Group II.

If the tax to GDP ratio was higher than the per capita GDP, it was classified as Group III.

If the tax to GDP ratio was very much higher than per capita GDP, the country was placed in Group IV.

For those countries with a high export potential in the extractive or agro-export industries, the extractive or agro-export industry criterion modifies these results upward, increasing a group's previously analysed potential (from very low to low, from low to medium or from medium to high).

As with the previous scenario, the prospects of an increase in the tax to GDP ratio for each country are analysed with reference to an ambitious Option A and a more moderate Option B.

**Table 5 Revenue potential through increases in the tax to GDP ratio (various countries)**

Country/region	GDP p.c. \$	Tax revenue (% GDP)	Tax collection potential in Option A (\$m)	Tax collection potential in Option B (\$m)
<b>Latin America</b>				
<b>Group I (high potential)</b>				
Argentina**	8,236	13.7	13,138.6	6,569.3
Chile**	10,084	19.5	6,778.3	3,389.2
Colombia	5,416	13.5	9,750.6	4,875.3
Costa Rica	6,564	15.3	1,186.5	593.3

Ecuador**	4,056	12.5	2,187.4	1,093.7
El Salvador	3,605	13	884.6	442.3
Guatemala	2,848	11.3	1,559.3	779.7
Mexico	10,232	9.01	43,525.2	21,762.6
Panama	6,793	10.8	923.5	461.8
Paraguay**	2,561	12.4	639.1	319.5
Peru**	4,477	15.6	5,164.4	2,582.2
Dominican Republic	4,576	14.9	1,821.6	910.8
Uruguay	9,654	17.1	1,287.4	643.7
Venezuela, (Bolivarian Republic of)**	11,246	13.5	12,566.0	6283
<b>group II (medium potential)</b>				
Bolivia	1,720	19	333.5	166.7
Brazil**	8,205	26.7	31,503.0	15,751.5
Honduras	1,823	14.7	266.9	133.4
Nicaragua	1,163	17.6	131.8	65.9
<b>GDP weighted average</b>		<b>18</b>	<b>133,648.0</b>	<b>66,823.9</b>
<b>Africa</b>				
<b>group I (high potential)</b>				
Algeria**	4,845	8	6,661.8	3,330.9
Botswana**	6,982	30.2	536.5	268.3
Cameroon**	1,226	18.5	935.8	467.9
Chad*	770	5.3	336	168
Congo Republic*	2,966	6,1	428.9	214.4
Egypt**	1,991	15.4	6,491.3	3,245.7
Mauritania**	889	13.4	114.3	57.2
Mauritius	7,345	19	372.8	186.4
Nigeria**	1,370	5.9	8,284.7	4,142.4
Zambia**	1,134	17.5	572.6	286.3
<b>Group II (medium potential)</b>				
Burkina Faso	522	12.1	159	79.5
Ghana**	713	20.6	333.1	166.5
Kenya**	783	20.9	607.1	303.5
Mali**	688	15	174.8	87.4
Mozambique**	440	14.2	196.9	98.5
Namibia**	4,149	24.8	176.7	88.4
Niger**	364	11.4	107.1	53.5
Senegal	1,087	18.3	265.5	132.7
South Africa	5,678	25.7	5,528.9	2,764.5
Tunisia	3,903	22.4	806.2	403.1
<b>Group III (low potential)</b>				
Benin	771	17.2	66.8	33.4
Guinea*	386	14.7	38	19
Madagascar	495	12.9	94.6	47.3
Morocco	2,769	26.9	888.8	444.4
Tanzania	496	14.8	204.9	102.5
<b>Group IV (very low potential)</b>				
Burundi	144	18	0	0

<b>GDP weighted average</b>		<b>17</b>	<b>34,383.2</b>	<b>17,191.6</b>
<b>Asia</b>				
<b>Group I (high potential)</b>				
Bangladesh	497	8.8	3,182.2	1,591.1
India	1,017	12.9	46,366.8	23,183.4
Indonesia	2,246	11	20,429.2	10,214.6
Malaysia	8,209	17.58	8,870.9	4,435.5
Philippines	1,847	14.1	6,676.4	3,338.2
Sri Lanka	2,013	14.2	1,622.6	811.3
Thailand	4,043	16.5	10,897.2	5,448.6
Viet Nam	1,051	13.8	3,625.8	1,812.9
<b>GDP weighted average</b>		<b>13</b>	<b>101,671</b>	<b>50,835</b>
			<b>Tax collection potential A</b>	<b>Tax collection potential B</b>
		<b>Total</b>	<b>269,702</b>	<b>134,851</b>
		<b>*Fragile states</b>	<b>910</b>	<b>455</b>
		<b>Without fragile states</b>	<b>268,792</b>	<b>134,396</b>

Source: Our compilation using: ECLAC, World Bank Tax Revenue, and *African Economic Outlook*<sup>193</sup> (accessed December 2010)

\*\*Countries with export potential (extractive or agricultural industries)

**Under the more ambitious Option A, the tax burden would be increased by**

- 4 per cent of GDP for countries in Group I
- 2 per cent of GDP for countries in Group II
- 1 per cent of GDP for countries in Group III
- 0 per cent of GDP for countries in Group IV

**Under the more moderate Option B, the tax burden would be increased by**

- 2 per cent of GDP for countries in Group I
- 1 per cent of GDP for countries in Group II
- 0.5 per cent of GDP for countries in Group III
- 0 per cent of GDP for countries in Group IV

Taking into account the proposed improvement in tax collection in the countries analysed, **a revenue increase of \$269bn could be obtained in Option A and an increase of \$134bn in Option B.** See Annex 3 for more details of these calculations.

On the face of it, these are perfectly attainable goals, considering the low starting point of the tax to GDP ratio in most developing countries and their tax collection potential. These estimates are consistent with those of McKinley and Kyrili who consider that a tax to GDP ratio of 15 to 20 per cent, as a minimum desirable goal, is perfectly attainable in the vast majority of developing countries.<sup>194</sup> Similar approach has done by Keen and Simone.<sup>195</sup>

## Calculation of potential for the Millennium Development Goals and/or basic social services

What would be the effect of this tax collection potential on financing the achievement of the Millennium Development Goals across the board or on specific sectors such as education or health?

### *a. Millennium Development Goals (MDGs)*

According to UN figures, the financing required (from both internal and external sources) to meet the MDGs was approximately \$454bn in 2010.<sup>196</sup> This financing requirement could be covered by up to 60 per cent simply by implementing the most ambitious Option A of the second scenario (i.e. increasing the tax to GDP ratio) in the countries studied. It is worth noting that these countries represent 46 per cent of the world's population or 56 per cent of developing countries' population. The more moderate Option B in the second scenario would meet almost 30 per cent of MDG costs.

In countries with a low potential for increasing their tax to GDP ratios, the MDG financing gap could not be covered. However, if a surplus were generated in most of the other countries, **ODA could then be re-oriented towards the poorest countries** that currently have the least potential for generating enough domestic resources to fulfil the Millennium Development Goals. At the same time, appropriate assistance could be provided to developing countries to help them make the most of their capacity to generate their own revenues.

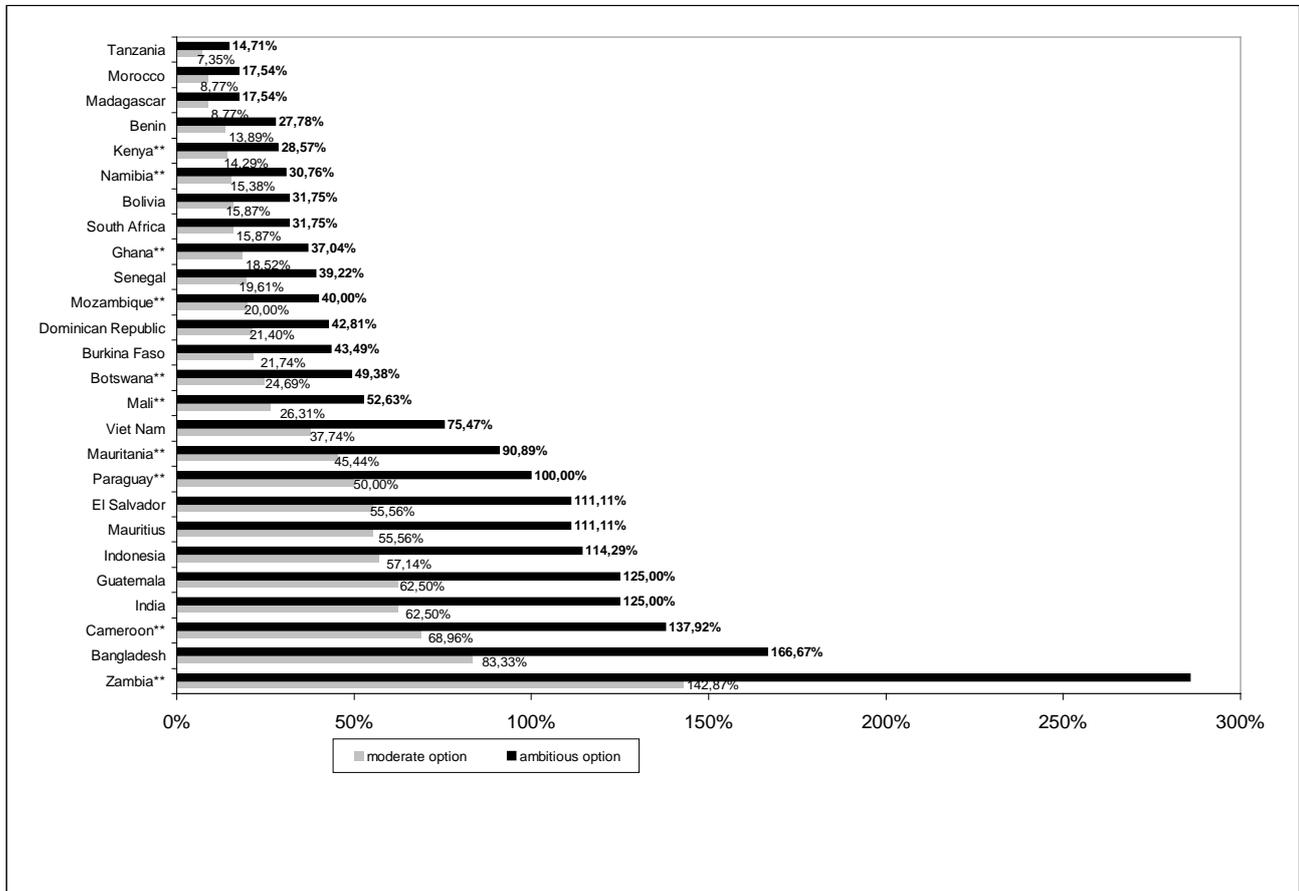
If the potential to increase tax to GDP ratios is compared with the financing requirements of the MDG to end hunger, then the proportion of the current gap that could be filled would be even greater. Achieving this goal would require an estimated \$90.8bn<sup>197</sup> of which \$15.8bn would come from ODA already assigned to this MDG, leaving \$75bn of additional resources needed. Therefore the financing gap would be covered almost three times over, just by implementing the most ambitious option in the second scenario.

### *b. Basic social services*

Improving tax collection potential by increasing the tax to GDP ratio (as explored in the second scenario above, Option A) would have significant implications for public investment in education and health.

Figure 9 shows the potential increase in spending on education that could result from an increase in tax to GDP ratios, based on the proportion of public revenues currently spent on education. This underlines the importance of trying to implement such tax reforms in a broad range of countries.

**Figure 9 Potential percentage increase in education expenditure as a result of increasing the tax to GDP ratio (various countries)**

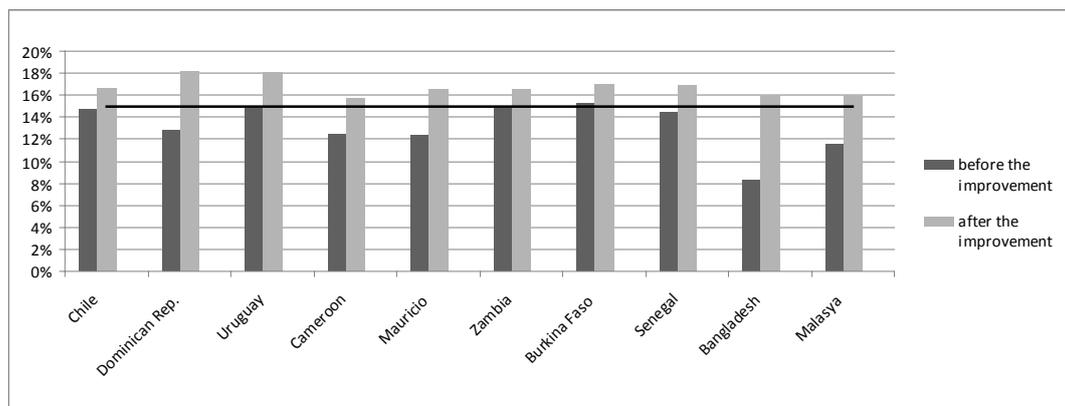


Sources: Our compilation based on our calculations (Table 5) and latest World Bank data (accessed January 2011)<sup>198</sup>

\*\*Countries with export potential (extractive or agricultural industries)

In Figure 10, a hypothesis of channelling 40 per cent of a potential increase in tax revenues to health has been applied. It shows the proportion of the total public spending budget that would be spent on health before and after such a 40 per cent increase in tax revenues dedicated to health. The black line across Figure 10 at the 15 per cent mark represents the international target of directing 15 per cent of public spending to health. **In the countries analysed, it is clear that the 40 per cent of additional tax revenue added to the current health expenditure would enable these countries to surpass the goal of allocating 15 per cent of total public spending to health.**

**Figure 10 Health spending as a percentage of total public expenditure (Second scenario, Option A)**



Sources: Our compilation based on our calculations and latest World Bank data (accessed December 2010)<sup>199</sup>

Note: The evolution of health spending is compared to total spending (including the potential revenue collection improvement) and to the international 15 per cent goal.

In reality it is up to each country to decide how to spend tax revenue. But if the proposed tax reforms were successful, they could increase resources for financing basic services quite significantly. In addition to allocating 40 per cent of the increased tax revenue to health and education respectively, the remaining 20 per cent could be left to a government's discretion, depending on the specific needs of each country (e.g. social inclusion programmes, the fight against hunger, social services, and investment in infrastructure and Research, Development, and Innovation, or even increasing the percentage dedicated to education and health, if considered appropriate).

In countries with extractive or agro-exporting industries (marked by a double asterisk in Table 5), it is suggested that a share of the increase in tax collection (for example, 50 per cent) might be allocated to a specific fund in order to reduce dependence on such industries and develop other sectors of the economy. Given the volatility of commodity prices, the fund could serve as a contingency to avoid an abrupt drop in public revenue at times when income from commodities is low. In countries dependent on extractive industries, a reconversion plan is essential, given that the resources being extracted are non-renewable.<sup>200</sup> The creation of such a fund would mean that the proposed increase in tax revenue channelled into education and health would be 50 per cent lower in these countries. Thus, education and health would get 20 per cent of the revenues respectively, leaving the remaining 10 per cent available for other purposes.

The total amount that could be generated for such a fund in countries dependent on extractives and agro-exports would be **\$32bn per year under the more ambitious Option A and half that figure under the more moderate Option B.**

## 8. Conclusion

The creation of a fairer tax system is an unresolved matter for developing countries. The evidence confirms that a failure to find ways of taxing more fairly seriously constrains developing countries' ability to fulfil poverty reduction and equity objectives, as well as their ability to build more stable states.

Tax policy and public spending policy need to be yoked together in order to fulfil social goals. One of the main conclusions of this research report is that governments in developing countries have not made the most of tax policies as a tool for achieving such goals. Policies promoted by IFIs have tended to undermine positive reforms aimed at dealing with inequality, while the interests of international private investors in low taxation have not helped.

Indicators supporting the assertion that tax policy has failed in developing countries include:

1. **Final revenues fall short** of those that theoretically could be obtained when countries' productive potential is analysed, and such revenues as are collected do not meet the financial needs to support the fight against poverty.
2. **An imbalance between direct and indirect taxes in total revenue collection** occurs because very little tax revenue is obtained from taxing the owners of capital; instead taxation has focused on levying taxes on consumption that are potentially regressive.
3. **Tax exemptions intended to fulfil objectives that go beyond purely social ones. These exemptions often dramatically reduce the tax base**, chiefly benefiting rich people and bolstering the profits of national and international companies. There is little evidence to indicate that these exemptions act as an incentive for attracting the kind of value-added investments that would have a positive impact on development.
4. **The continuous growth of the informal economy, which shelters tax dodging** by medium and large companies and contributes to the systematic violation of the rights of poor, vulnerable workers. **Those measures which are taken to tax the informal economy or enforce regulations are often arbitrary and fail to deal fairly with conflicting interests.**

Although the responsibility of developing countries themselves for this situation cannot be denied, international actors also have also played an important role:

1. **IFI demands and conditions, which favour economic efficiency and short-term collection goals over any other objective, have resulted in the promotion of taxes with low political costs** that affect the interests of private companies and the wealthiest strata of the population as little as possible. These taxes are easier to collect but are not necessarily the most appropriate for the circumstances in developing countries. **The potential impact of these taxes on redistribution was not analysed carefully enough and, as a result, insufficient measures were taken to limit the potentially negative impact on the poorest sections of the population.**
2. **The coherence between this tax doctrine and other broader IMF and World Bank policies**, such as redistribution via public spending or tax exemptions to promote foreign investments, is unclear.
3. **Secrecy jurisdictions, commonly known as tax havens, have been a barrier to increasing taxation** of the richest sectors and of companies that operate in developing countries.

4. **There has been a proliferation of unjust corporate practices, such as the altering of intra-group trading prices (in multinationals)**, and an increase in the opacity of multinationals' financial accounts. These practices make any real attempt to monitor the expropriation of financial resources from developing countries a farce. On the two last points, developed countries facing the same challenges have a double responsibility to act urgently, while transparency measures needed are in their hands.
5. **To date, ODA policies have played too limited a role in promoting fair tax systems.** Consequently there is considerable potential for donors to now support governments in the process of constructing systems for more efficient and effective tax collection and to back reforms and policies that will promote transparency in the handling of public finances at all levels of government.

All of the above trends can and should be reversed. As a rule, tax policy should play a bigger role in environments where significant funding is needed to reduce poverty and high inequality, albeit combined with other efforts, such as more focused public spending towards the poor.

## Annex 1

### Data sources

There are important differences between the World Bank's tax revenue data as a percentage of GDP and each of the other sources used, including the OECD, *African Economic Outlook*, and the Economic Commission for Latin America and the Caribbean (ECLAC). This is because each institution takes a different approach towards what is included as tax collection. Some of the differences arise over income from sub-national levels of government, taxes of social security contributions, and revenues/rents (not strictly taxes) that come from extractive industries.

For example, in Algeria, in the 2008 financial year, *African Economic Outlook* calculated the tax ratio to be 8 per cent of GDP (40.2 per cent, including revenues/rents from the extractive industry), but, according to the World Bank, it was 46.5 per cent. In Brazil, in the 2008 financial year, according to ECLAC, the central government collected taxes worth 16.6 per cent of GDP (and government overall, 26.2 per cent) but according to World Bank data, central government collection was 16.3 per cent of GDP.

For the purposes of this report, social security contributions were treated as revenue for a specific purpose and not as taxes. Unless otherwise specified, our calculations of the tax to GDP ratio exclude social security contributions.

We used World Bank data to compare changes in the tax to GDP ratio between regions from the early 1990s because the World Bank has data that goes back that far.

- **World Bank:** Includes all tax revenue from economic activities (assumed to include extractive activity), but only provides data at central government level. The World Bank excludes social security contributions in the computation of tax revenue. It is not possible to identify the portion of tax revenue or rents from extractive activity (<http://data.worldbank.org/indicator/GC.TAX.TOTL.GD.ZS>).
- **ECLAC:** Distinguishes between central government and non-central tax and social security contributions, but we cannot identify what is received through taxation of extractive activities (<http://websie.eclac.cl/sisgen/ConsultaIntegrada.asp?idAplicacion=6&idTema=140&idioma>).
- **OECD:** Data includes social security contributions and taxes collected by supranational, national, and sub-national governments (<http://www.oecd.org/dataoecd/13/38/46721091.xls>).
- **African Economic Outlook:** Does not discriminate between central government and non-central / tax and social security contributions; in general, we can identify what is received through rents of extractive industries. For that reason, when it was possible, we have omitted rents or revenue that come from oil or mining industries. For example, under Nigeria's statistic 'Oil accounts for about 27.4 per cent of GDP in 2008', see: <http://www.africaneconomicoutlook.org/en/countries/west-africa/nigeria/>

It is possible that data on tax to GDP ratios, especially in the case of Botswana, Cameroon, Kenya, and Mali, includes rents or revenue from extractive industries, especially mining. However, the data available from AEO does not permit us to identify the specific share for the extractive industries in these countries. Moreover, an analysis undertaken by the Tax Justice Network on taxation in Africa suggests that the data on tax to GDP ratios in Burundi, Mauritius, and Tunisia may contain public revenue that is not strictly taxes.<sup>201</sup> Even taking into account these considerations, we must stress that for the purposes of the estimates in Tables 4 and 5, these issues do not modify significantly the estimates of the potential for tax collection in the countries studied.

## Annex 2

### Data on inequalities in income and basic services (various countries)

	Income or expenditure size (%)		Measures of inequity		% Childbirths attended by specialised health staff	
	Poorest 10%	Richest 10%	Richest 10% / Poorest 10%	Gini index	Poorest 20 per cent population	Richest 20 per cent population
Singapore	1.9	32.8	17.7	42.5		
Hong Kong, China (SAR)	2.0	34.9	17.8	43.4		
North Korea	2.9	22.5	7.8	31.6		
Israel	2.1	28.8	13.4	39.2		
Slovenia	3.4	24.6	7.3	31.2		
Brunei	..	..	..	..		
Kuwait	..	..	..	..		
Cyprus	..	..	..	..		
Qatar	..	..	..	..		
UAE	..	..	..	..		
Czech Republic	4.3	22.7	5.3	25.8		
Barbados	..	..	..	..		
Malta	..	..	..	..		
Bahrain	..	..	..	..		
Estonia	2.7	27.7	10.4	36.0		
Poland	3.0	27.2	9.0	34.9		
Slovakia	3.1	20.8	6.8	25.8		
Hungary	3.5	24.1	6.8	30.0		
Chile	1.6	41.7	26.2	52.0		
Croatia	3.6	23.1	6.4	29.0		
Lithuania	2.7	27.4	10.3	35.8		
Latvia	2.7	27.4	10.3	35.7		
Argentina	1.2	37.3	31.6	50.0		
Uruguay	1.7	34.8	20.1	46.2		
Cuba	..	..	..	..		
Bahamas	..	..	..	..		
Mexico	1.8	37.9	21.0	48.1		
Costa Rica	1.5	35.5	23.4	47.2		
Venezuela (Bolivarian Republic of)	1.7	32.7	18.8	43.4		
Saudi Arabia	..	..	..	..		
Panama	0.8	41.4	49.9	54.9		
Bulgaria	3.5	23.8	6.9	29.2		
Romania	3.3	25.3	7.6	31.5		
Trinidad and Tobago	2.1	29.9	14.4	40.3		

Malaysia	2.6	28.5	11.0	37.9		
Albania	3.2	25.9	8.0	33.0		
Russian Federation	2.6	28.4	11.0	37.5		
Brazil	1.1	43.0	40.6	55.0	72	99
Bosnia Herzegovina	2.8	27.4	9.9	35.8		
Colombia	0.8	45.9	60.4	58.5	72.0	99.0
Peru	1.5	37.9	26.1	49.6	34.0	100.0
Turkey	1.9	33.2	17.4	43.2	53.0	98.0
Ecuador	1.2	43.3	35.2	54.4		
Mauritius	..	..	..	..		
Kazakhstan	3.1	25.9	8.5	33.9	99.0	99.0
Armenia	3.7	28.9	7.9	33.8	96.0	100.0
Ukraine	3.8	22.5	6.0	28.2		
Azerbaijan	6.1	17.5	2.9	36.5		
Thailand	2.6	33.7	13.1	42.5	93.0	100.0
Dominican Republic	1.5	38.7	25.3	50.0	89.0	98.0
China	2.4	31.4	13.2	41.5		
Tunisia	2.4	31.6	13.3	40.8		
Tonga	..	..	..	..		
Jamaica	2.1	35.6	17.0	45.5		
Paraguay	1.1	42.3	38.8	53.2		
Sri Lanka	2.9	33.3	11.7	41.1		
Gabon	2.5	32.7	13.3	41.5		
Algeria	2.8	26.9	9.6	35.3		
Philippines	2.4	33.9	14.1	44.0	25.0	92.0
El Salvador	1.0	37.0	38.6	49.7		
Indonesia	3.0	32.3	10.8	39.4	21.0	89.0
Honduras	0.7	42.2	59.4	55.3	41.0	98.0
Bolivia	0.5	44.1	93.9	58.2	27.0	98.0
Viet Nam	3.1	29.8	9.7	37.8	58.0	100.0
Guatemala	1.3	42.4	33.9	53.7	9.0	92.0
Egypt	3.9	27.6	7.2	32.1	51.0	96.0
Nicaragua	1.4	41.8	31.0	52.3	78.0	99.0
Botswana	1.3	51.2	40.0	61.0		
Namibia	0.6	65.0	106.6	74.3	55.0	97.0
South Africa	1.3	44.9	35.1	57.8	68.0	98.0
Morocco	2.7	33.2	12.5	40.9	30.0	95.0
India	3.6	31.1	8.6	36.8	16.0	84.0
Congo	2.1	37.1	17.8	47.3	70.0	98.0
Angola	0.6	44.7	74.6	58.6		
Madagascar	2.6	41.5	15.9	47.2	30.0	94.0
Bangladesh	4.3	26.6	6.2	31.0	3.0	40.0
Kenya	1.8	37.8	21.3	47.7	17.0	75.0

Haiti	0.9	47.8	54.4	59.5	6.0	68.0
Tanzania	3.1	27.0	8.9	34.6	29.0	83.0
Ghana	2.0	32.8	16.1	42.8		
Cameroon	2.4	35.5	15.0	44.6	29.0	94.0
Mauritania	2.5	29.6	11.6	39.0	15.0	93.0
Djibouti	2.4	30.9	12.8	40.0		
Lesotho	1.0	39.4	39.8	52.5	34.0	83.0
Uganda	2.6	34.1	13.2	42.6	20.0	77.0
Nigeria	2.0	32.4	16.3	42.9	12.0	84.0
Togo	3.3	27.1	8.3	34.4	25.0	91.0
Malawi	3.0	31.9	10.5	39.0	43.0	83.0
Benin	2.9	31.0	10.8	38.6	50.0	99.0
Zambia	1.3	38.9	29.5	50.7	20.0	91.0
Senegal	2.5	30.1	11.9	39.2	20.0	89.0
Rwanda	2.1	37.8	18.1	46.7	27.0	66.0
the Gambia	2.0	36.9	18.9	47.3		
Liberia	2.4	30.1	12.8	52.6		
Guinea	2.4	34.4	14.4	43.3	15.0	87.0
Ethiopia	4.1	25.6	6.3	29.8	1.0	27.0
Mozambique	2.1	39.2	18.5	47.1	25.0	89.0
Guinea-Bissau	2.9	28.0	9.5	35.5		
Burundi	4.1	28.0	6.8	33.3		
Chad	2.6	30.8	11.8	39.8	4.0	55.0
Democratic Republic of Congo	2.3	34.7	15.1	44.4		
Burkina Faso	3.0	32.4	10.8	39.6	39.0	91.0
Mali	2.7	30.5	11.2	39.0	8.0	82.0
Central African Republic	2.1	33.0	15.7	43.6	14.0	82.0
Sierra Leone	2.6	33.6	12.8	42.5	27.0	83.0
Niger	2.3	35.7	15.3	43.9	21.0	71.0

Source: United Nations Development Programme (2007) Human Development Report 2007-2008 and United Nations Development Programme (2009) Human Development Report 2009

## Annex 3

### Methodology for calculating estimates of the potential increase in tax to GDP ratios in developing countries

**General premise:** The analysis is static and therefore does not consider the implications of the proposed measures on the overall economy in the short and medium term. Neither adverse effects, such as a possible withdrawal of investment, consumption, and / or savings as a result of tax increases, nor positive effects, such as increased public spending and investment as a result of higher revenues, are discussed.

Although the estimates were made on an annual basis, this does not mean that this potential collection will be achieved in a year.

#### Table 4 Tax revenue potential through formalisation (various countries)

Data source:

##### 1. Underground economy data as percentage of GDP

For almost all countries Schneider and Buehn (2009) was used. This data represents the estimates of the authors, based on two versions of an econometric model<sup>202</sup> (including and not including the 'unemployment rate' as one of the explanatory variables of the model). The data presented in Table 4 are the annual averages from 1999 to 2006. For most countries, the data is taken from the econometric model which includes 'unemployment' as an independent variable, as this is considered to be the best model. For countries with no information in the previous reference, Charmes (2000) is used<sup>203</sup> – based on Schneider's investigation – or Schneider and Enste (2000).<sup>204</sup>

Schneider and Buehn define the 'informal economy' as all market-based legal production of goods and services that are deliberately concealed from public authorities to avoid:

- payment of income tax, VAT, or other taxes;
- payment of social security contributions;
- having to meet certain legal labour market standards, such as minimum wages, maximum working hours, safety standards, etc;
- complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms.

##### 2. Informal employment size data as a percentage of total non-agricultural employment

Source: OECD (2009) – we included the most recent data available from the source which is based on averages. The OECD document used the following information sources: Charmes (2002), Heintz and Chang (2007), and, for West Asia, Charmes (2007 and 2008).

##### 3. Data on tax revenue as a percentage of GDP (2008):

- for African countries: *African Economic Outlook* data from OECD<sup>205</sup>
- for American countries: ECLAC<sup>206</sup>
- for Asian countries: World Bank<sup>207</sup>

### Calculation assumptions:

- a. Potential revenue collection was calculated based on two options: one more ambitious (Option A) and another more moderate (Option B).
- b. Assumptions were made that countries vary in their potential revenue increase and that, where the informal economy constitutes a higher proportion of GDP, there is increased revenue potential. We therefore divided countries into three groups: **countries with high potential, medium potential and low potential countries**. With this we established the following ranges of reduction of the informal economy as a percentage of GDP: 15 per cent, 8 per cent, and 2 per cent respectively for each of these groups under the more ambitious option (A) and 7.5 per cent, 4 per cent, and 1 per cent under the moderate option (B).
- c. As seen in Table 4, the informal economy as a percentage of the GDP of each of these countries is very high: more than 45 per cent in Group I countries and between 23 and 45 per cent in Group II. The informal economy average in OECD countries is around 15 per cent of GDP.<sup>208</sup> The tax to GDP ratio of these countries is much higher and the percentage of informal employment within total non-agricultural employment is significantly lower.
- d. For purposes of validation of the potential mentioned above, we used the data of **informal employment size as a percentage of total non-agricultural employment**. In all cases the percentages of the non-agricultural informal economy were high. This means greater scope for reducing the informal economy.
- e. The calculation of the potential is obtained by multiplying the current GDP growth (in a scenario whereby the economy is formalised and GDP increases) and the current tax to GDP ratio. It is assumed that the tax to GDP ratio of each country remains the same. In other words, it is the amount of informal economy that could be formalised, as percentage of GDP, multiplied by the tax burden or collection as a percentage of GDP (third column in the table).
- f. To obtain the final potential, it is necessary to exclude the potential increase in tax collection from countries considered to be fragile states because they may not be in a position to undertake fiscal reforms.

### Table 5 (Revenue potential through increases in tax to GDP ratio [various countries])

#### Data source:

1. **GDP per capita data (World Bank)**
2. **Data on export potential**
  - extractive industries: International Energy Agency
  - agricultural industry: World Trade Organisation
3. **Data collection on tax revenue as a percentage of GDP (2008):**
  - for African countries: *African Economic Outlook* OECD data<sup>209</sup>
  - for American countries: ECLAC<sup>210</sup>
  - for Asian countries: World Bank<sup>211</sup>

Various sources have been used as estimates of revenue because the World Bank data tends to be over-estimated.

**Calculation assumptions:**

Potential revenue collection has been calculated based on two options: one more ambitious (option A) and another more moderate (option B).

- a. We have assumed that countries vary in their potential revenue increase. Countries that have relatively high per capita GDP and a low tax to GDP ratio have more scope to increase revenues than those with relatively low per capita GDP and a higher tax to GDP ratio. We also judged that countries with large extractive industries or an important agro-export sector have greater collection potential and took this factor into account in deciding which group countries should go into.
- b. Based on the assumptions outlined above, countries were divided into high potential, medium potential, low potential, and very-low potential countries. Increased tax collection of 4 per cent, 2 per cent, and 1 per cent of GDP was modelled for each of these groups in the ambitious option A and 2 per cent, 1 per cent, and 0.5 per cent in the more moderate option B. These estimates are consistent with other research.<sup>212</sup>
- c. The calculation of the potential is obtained by multiplying the percentage of the projected revenue increase by the GDP.
- d. To obtain the final potential, it is necessary to exclude the potential increase in tax collection from countries considered to be fragile states which may not be in a position to undertake fiscal reforms.

## Notes

<sup>1</sup> Excluding South Africa.

<sup>2</sup> Green, King, and Miller-Dawkins (2010)

<sup>3</sup> Kar and Curcio (2011)

<sup>4</sup> Hollingshead (2010)

<sup>5</sup> Our calculations based on World Bank data. See Annex 1 for details on the source.

<sup>6</sup> Our calculations using OECD data. See Annex 1 for details on the source.

<sup>7</sup> Our calculations based on World Bank data. See Annex 1 for details on the source.

<sup>8</sup> Taken from the Tax Justice Network (TJN) with reference to the International Monetary Fund's (IMF) Quarterly Finance and Development magazine, September 2008, Volume 45, Number 3, <http://taxjustice.blogspot.com/2008/08/in-africa-pay-more-attention-to-tax-imf.html>

<sup>9</sup> Gupta and Tareq (2008), <http://www.imf.org/external/pubs/ft/fandd/2008/09/gupta.htm>

<sup>10</sup> In the past 30 years, growth in South-East Asia and Latin America has also been accompanied by an increase in informal employment.

<sup>11</sup> Our calculations based on OECD (Development Co-operation Directorate (DCD-DAC)) data, <http://www.oecd.org/dataoecd/50/17/5037721.htm> (accessed February 2011)

<sup>12</sup> No one can be obliged to use the services or is prosecuted for not using them. However, as the state monopolises certain public services that are taxed, their use becomes obligatory as a consequence of both the monopoly and the need. This indirect form of coercion is very different from the legal coercion that is used to ensure payment of the tax.

<sup>13</sup> The basic features that distinguishes one tax from another.

<sup>14</sup> The effect on revenue distribution according to theory and empirical evidence: the tax burden falls differently on the different economic sectors of a population. It creates a new 'after-tax' income distribution. This column explains whether this distribution is progressive or not.

<sup>15</sup> The distortion of the market: this refers to a tax's degree of efficiency. Efficiency indicates the capacity for revenue collection while interfering as little as possible in production. It is therefore related to the administrative costs generated by the tax. This is also related to the way the tax distorts the relative prices among goods in a market. The ability of a price system to faithfully reflect production costs and demand is essential for generating the most efficient distribution of resources (i.e. to obtain more goods with less effort).

<sup>16</sup> Both the state and the taxpayer (whether an individual or a legal entity, such as a business) will incur administrative costs when complying with the collection or payment of a tax, according to their circumstances. This cost is influenced by the incorporation of appropriate technology and the training and deployment of personnel, among other elements.

<sup>17</sup> Long-term projects tend to generate losses in their first years of life. Therefore, during their initial years (when tax holidays are in place) they cannot benefit from this incentive, since they have few if any profits on which to be taxed.

Often, when they do begin to generate profit (in, for example, 10 years), the tax incentive has already expired. Tax holidays do not encourage a company whose project is long-term to settle in a developing country. It is companies with short-term projects who are attracted by tax holidays, because they are confident that in their first years they will obtain profits, and the tax holiday incentive will exempt them from paying any tax on these. When the incentive ends, they pack up and leave.

<sup>18</sup> See Marshall (2009)

<sup>19</sup> The VAT paid upon purchasing goods or services.

<sup>20</sup> The VAT applied to the sale of a product or service to the end consumer.

<sup>21</sup> One feature of VAT is that it gives tax credit to the buyer of intermediate goods. Thus an agent who buys an input – and is charged the corresponding VAT on the purchase – and then sells it on to the next link in the production chain, may deduct the VAT that is due to be paid in sales tax with

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the VAT credit that has already been paid in purchases. In this way the tax falls only on the final consumer, as this VAT refund system exempts producers from this tax. In turn, if the system works properly, even though many stages may be involved in the process, the rate charged on the final product will be the same as the one applied at the beginning of the process.

<sup>22</sup> Oxfam (2010)

<sup>23</sup> Eurodad and ActionAid (2011)

<sup>24</sup> *Ibid.*

<sup>25</sup> Oxfam (Unpublished)

<sup>26</sup> A 'race to the bottom' is a socio-economic concept that is said to occur between countries as an outcome of regulatory competition. When there is fierce competition between nations over a particular area of trade and production, countries are given increased incentives to dismantle currently existing regulatory standards. In practice this has resulted in lower tax rates and numerous tax incentives for the private sector.

<sup>27</sup> International Monetary Fund (2011)

<sup>28</sup> Kar and Curcio (2011)

<sup>29</sup> Also known as fiduciary funds: these can be defined as a legal business or contract through which a person called a 'trustor' transfers ownership of one or more goods (which become the trust estate) to another person called a 'fiduciary' or trustee. After a period of time has passed or when a condition has been met, the trustee carries out the purpose or result established by the trustor, either in his favour or in favour of a third party called a 'beneficiary'. The problem is that it is almost impossible to monitor this type of transaction, as most of the times relevant authorities do not have access to the real 'trustor' or 'beneficiary' identities.

<sup>30</sup> The definition of tax havens as 'secrecy jurisdictions' has notably been emphasised by the Tax Justice Network (TJN) through their 'Financial Secrecy Index', a civil society list of tax havens: <http://www.financialsecrecyindex.com/>

<sup>31</sup> Hollingshead (2010)

<sup>32</sup> According to GFI, for methodological reasons these estimates are low in the case of African countries (Hollingshead 2010). For the implied tax revenue loss by trade mispricing, see [www.gfip.org/index.php?option=content&task=view&id=293](http://www.gfip.org/index.php?option=content&task=view&id=293) (accessed January 2011)

<sup>33</sup> ActionAid (2009)

<sup>34</sup> See International Monetary Fund (2005)

<sup>35</sup> Tax Justice Network (TJN), <http://taxjustice.blogspot.com/2008/08/in-africa-pay-more-attention-to-tax-imf.html> (accessed February 2011)

<sup>36</sup> Pérez, Gistelinck, and Karbala (2011)

<sup>37</sup> The extractive industries (oil and mining) are a case in point. Multinational extractive corporations often receive the backing of international institutions and their own governments in negotiations, as is shown in the case of Bolivia quoted in 'Lifting the Resource Curse. How poor people can and should benefit from the revenues of extractive industries', Oxfam (2009).

<sup>38</sup> Garcimartín, Rodríguez and Gayo (2006)

<sup>39</sup> Rozner (2009)

<sup>40</sup> Our calculations based on World Bank data. See Annex 1 for details on the data source.

<sup>41</sup> The estimates were based on GDP-weighted averages. South Africa represents 65 per cent of the sample's GDP in the area in the period 2006–08. In the Pacific and Eastern Asia region, neither Australia nor Japan is included, and China's results dominate and influence the final result. In the Latin American–Caribbean region, Brazil is not included, and the increase of fiscal pressure in Peru and Chile (mineral exporting countries) greatly influences the overall regional increase. In Eastern Europe, the data from 1990 to 1993 is not significant because information is only available from three countries. However, after that time the tax to GDP ratios of all of the countries in the sample are fairly homogenous.

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- <sup>42</sup> Calculations using data from *African Economic Outlook*. For more information, see: <http://www.africaneconomicoutlook.org/en/in-depth/public-resource-mobilisation-and-aid/the-state-of-public-resource-mobilisation-in-africa/tax-mix-in-africa/> (accessed February 2011)
- <sup>43</sup> Our calculations based on World Bank data. See Annex 1 for details on the data source.
- <sup>44</sup> Rozner (2009)
- <sup>45</sup> Norregaard and Khan (2007)
- <sup>46</sup> World Bank Group and PricewaterhouseCoopers International (2011)
- <sup>47</sup> Rozner (2009)
- <sup>48</sup> OECD Data.
- <sup>49</sup> Keen and Simone (2004), quoted in Volkerink (2009)
- <sup>50</sup> de Mooij and Nicodème (2008)
- <sup>51</sup> Rozner (2009)
- <sup>52</sup> *Ibid.*
- <sup>53</sup> Without such alignment there would be incentives for high-income professionals (such as accountants or lawyers) to include their personal earnings as part of the company's transactions in order to reduce their tax liabilities.
- <sup>54</sup> Volkerink (2009)
- <sup>55</sup> In OECD countries direct taxation is approximately 13 per cent of GDP.
- <sup>56</sup> In 2004, a fiscal reform law was approved, the main goal of which was the formalisation of the economy, the broadening of the VAT tax base, the introduction of personal income tax, and a tax on agricultural activities (IMAGRO).
- <sup>57</sup> Volkerink (2009)
- <sup>58</sup> Prichard (2009)
- <sup>59</sup> *Ibid.*
- <sup>60</sup> Cooperative Housing Foundation (2004), quoted in Prichard (2009)
- <sup>61</sup> *Ibid.*
- <sup>62</sup> Ministry of Finance and Economic Planning, Republic of Ghana, [http://www.mofep.gov.gh/fiscal\\_data.htm](http://www.mofep.gov.gh/fiscal_data.htm)
- <sup>63</sup> Agencia Nationale de la Statistique et de la Demographie (2010), Republique du Senegal.
- <sup>64</sup> See ECLAC website for more details: <http://websie.eclac.cl/infest/ajax/cepalstat.asp?carpeta=publicaciones> (accessed February 2011)
- <sup>65</sup> The calculation was made by dividing the revenue obtained from the goods and services in the economy and the tax rate, to obtain the percentage of goods taxed at the corresponding tax rate.
- <sup>66</sup> Volkerink (2009)
- <sup>67</sup> Shahe Emran is Assistant Professor of Economy and International Affairs at George Washington University.
- <sup>68</sup> Depending on the VAT model implemented.
- <sup>69</sup> Usually the product price is not set by the farmer but rather by the market. Therefore, the impact of the tax reduces the farmer's profit; the state does not refund the taxes paid because these are exempt agricultural goods.
- <sup>70</sup> Stiglitz and Emran (2007)
- <sup>71</sup> See World Bank Group and PricewaterhouseCoopers International (2011)
- <sup>72</sup> Our calculations using World Bank Tax data, ECLAC data, and OECD African Development Bank data. See Annex 1 for details on the data source.
- <sup>73</sup> Damme and Orel (2008)
- <sup>74</sup> Cubero and Vladkova Hollar (2010)

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- <sup>75</sup> Glenday (2006), Baunsgaard and Keen (2005), and International Monetary Fund (2005)
- <sup>76</sup> <http://www.africaneconomicoutlook.org/en/in-depth/public-resource-mobilisation-and-aid/> (accessed February 2011)
- <sup>77</sup> World Bank (2010), quoted in Acevedo (2009)
- <sup>78</sup> Applied, for example, to the consumption of alcoholic beverages, carbonated drinks, beer and cigarettes, tobacco products, and a list of imported goods classified as luxury.
- <sup>79</sup> Sabaini (2005), quoted in Acevedo (2009)
- <sup>80</sup> Artana and Gasparini (2003), quoted in *La (in)justicia tributaria en Nicaragua*, (Acevedo 2009)
- <sup>81</sup> *Ibid.*
- <sup>82</sup> Based on an exchange rate of \$21.39 / córdoba (correct as of 14 July 2010).
- <sup>83</sup> OECD countries apply taxes to the worldwide income of their citizens. To avoid double taxation, taxpayers can deduct the payments made through income tax in countries other than their country of origin (where they only pay taxes on income generated in that country). This means that when developing countries allow deductions or give tax subsidies to OECD country nationals, they are in practice subsidising the country of origin, since less tax paid in the country where the income is generated means more must be paid in the taxpayer's home country.
- <sup>84</sup> An example might be tax incentives to promote the development of green technology.
- <sup>85</sup> [http://www.taxguidebd.com/contents/tax\\_articles/8.pdf](http://www.taxguidebd.com/contents/tax_articles/8.pdf); pag. 3 and pag. 5
- <sup>86</sup> <http://www.receita.fazenda.gov.br/Publico/estudoTributarios/Eventos/WorkShopGastosTributarios/JuanPabloJimenezArtigo.pdf>; page 29
- <sup>87</sup> IEEPP (2010)
- <sup>88</sup> An example might be tax incentives to promote the development of green technology.
- <sup>89</sup> Free trade zones in Latin America and the Caribbean: Argentina 11, Belize 1, Bolivia 12, Brazil 1, Chile 2, Colombia 9, Costa Rica 19, Ecuador 7, El Salvador 4, Guatemala 5, Honduras 9, Mexico 1, Nicaragua 24, Panama 1, Paraguay 2, Peru 4, Puerto Rico 1, Dominican Republic 49, Uruguay 9, Bolivarian Republic of Venezuela 1.
- <sup>90</sup> Volkerink (2009)
- <sup>91</sup> Keen and Simone (2004)
- <sup>92</sup> Institutos de Estudios Estratégicos y Políticas Públicas (<http://www.ieepp.org/>)
- <sup>93</sup> <http://www.doingbusiness.org/economyrankings/> (accessed February 2011)
- <sup>94</sup> 'ITUC calls on World Bank to complete overhaul of "Doing Business"' <http://www.ituc-csi.org/ituc-calls-on-world-bank-to.html> (accessed February 2011)
- <sup>95</sup> Southern Africa Resource Watch (SARW), TWN Africa, Tax Justice Network Africa, ActionAid, and Christian Aid (2009)
- <sup>96</sup> Oxfam (Unpublished)
- <sup>97</sup> International Labour Organization (1998), *Labour and social issues relating to the export processing zones*
- <sup>98</sup> 'ITUC calls on World Bank to complete overhaul of "Doing Business"', *op cit.*
- <sup>99</sup> OECD Development Centre (2009)
- <sup>100</sup> Our calculations based on OECD data.
- <sup>101</sup> McKinsey and Company 2009 quoted in Inter-American Development Bank (2010)
- <sup>102</sup> Almand Martinez-Vasquez (2003) and Terkper (2003) quoted in Joshi and Aye (2008)
- <sup>103</sup> The black market (sometimes known as underground or black economy) denotes trade, goods, and services that are not part of the official economy of a country; this may be legal activities where taxes are not paid, or illegal activities, such as drug trafficking, arms trafficking, and prostitution.
- <sup>104</sup> International Labour Organization (2010)

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- <sup>105</sup> 'Polvos azules, el mercado de Lima donde todo es posible' [Polvos azules, the market where everything is possible], *Terra Magazine*, 26 May 2008  
<http://www.ar.terra.com/terramagazine/interna/0,,OI2908243-EI11329,00.html> (accessed February 2011)
- <sup>106</sup> <http://www.globovision.com/index.php> (accessed February 2011)
- <sup>107</sup> [http://www.metropolitana.org.ar/idm/idm\\_35/idm\\_35\\_nota\\_02.html](http://www.metropolitana.org.ar/idm/idm_35/idm_35_nota_02.html) (accessed February 2011)
- <sup>108</sup> See World Bank (2007)
- <sup>109</sup> Bonner (2006), page 23
- <sup>110</sup> *Ibid.*
- <sup>111</sup> Bonner (2006), page 22
- <sup>112</sup> According to the ILO, decent work has the following characteristics:  
'it is productive and secure work, it ensures respect of labour rights, it provides an adequate income, it offers social protection, it includes social dialogue, union freedom, collective bargaining and participation.'
- <sup>113</sup> Green, King and Miller-Dawkins (2010)
- <sup>114</sup> OECD *op cit.*
- <sup>115</sup> International Labour Organization *op cit.*
- <sup>116</sup> Joshi and Ayee (2008)
- <sup>117</sup> Testimony quoted in CSI - International Trade Union Confederation (2007) *op cit.*
- <sup>118</sup> Bonner (2006)
- <sup>119</sup> Inter-American Development Bank (2010)
- <sup>120</sup> Panama is considered a tax haven, which in practice means the conditions there favour tax dodging.
- <sup>121</sup> McKinsey and Company 2009 quoted in Inter-American Development Bank *op cit.*
- <sup>122</sup> Inter-American Development Bank *op cit.*
- <sup>123</sup> *Ibid.*
- <sup>124</sup> The first decree was from 05/10/2001 to 30/11/2001. After 28/04/2002 labour immobility was valid for an additional 60 days. This latest one has been extended with different decrees and different terms, lasting up to the present. See details on website:  
<http://cciavf.com.ve/boletin/Feb2009/inamovilidad-laboral.pdf> (accessed February 2011)
- <sup>125</sup> Prichard (2009)
- <sup>126</sup> *Ibid.*
- <sup>127</sup> Peruvian National Institute for Statistics and Information, <http://www.inei.gob.pe/> (accessed January 2011)
- <sup>128</sup> Economic Commission for Latin America and the Caribbean  
<http://websie.eclac.cl/infest/ajax/cepalstat.asp?carpeta=publicaciones> (accessed February 2011)
- <sup>129</sup> For a more detailed discussion see von Haldenwang (2008)
- <sup>130</sup> Prichard (2009)
- <sup>131</sup> The 1990 Finance Law distributes the income from sewer taxes as follows: 60 per cent for Cotonou, 24 per cent for Porto Novo, and 16 per cent for Parakou.
- <sup>132</sup> Oxfam (2009)
- <sup>133</sup> *Ibid.*
- <sup>134</sup> Garcimartín, Rodríguez, and Gayo (2006)
- <sup>135</sup> *Ibid.*
- <sup>136</sup> Fjeldstad and Rakner (2003) quoted in Garcimartín *et al*, *op cit.*
- <sup>137</sup> ActionAid (2009)

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- <sup>138</sup> Cubero and Vladkova Hollar (2010)
- <sup>139</sup> The price of the products is set by the company or companies that market the product, in the absence of real price competition.
- <sup>140</sup> von Haldenwang (2008)
- <sup>141</sup> Quoted in Stiglitz and Emran (2007)
- <sup>142</sup> von Haldenwang *op cit*.
- <sup>143</sup> Listed at: [http://www.gender-budgets.org/index.php?option=com\\_joomdoc&task=cat\\_view&qid=194&Itemid=189](http://www.gender-budgets.org/index.php?option=com_joomdoc&task=cat_view&qid=194&Itemid=189) (accessed February 2011)
- <sup>144</sup> Because the loans are informal, the financing costs cannot be declared. This means that the declared added value (income declared minus costs) is greater than the real added value.
- <sup>145</sup> Graham and Pettinato (2002) and Luttmer (2004) quoted in Stewart, Brown, and Cobham (2009)
- <sup>146</sup> Bourignon (2001) quoted in Stewart, Brown, and Cobham (2009)
- <sup>147</sup> Economic inequality includes access to assets (financial, natural, human, and social), as well as employment and hence income. Inequality of access to basic social services includes variables such as education, health, social services, and housing. Economic inequality is also studied in relation to human development indicators (life expectancy, literacy, etc.) and, in its political dimension, horizontal inequality consists of the analysis of the degree of participation and political control of the group in a given society.
- <sup>148</sup> Stewart (2001); Collier and World Bank (2003) quoted in Stewart, Brown, and Cobham (2009)
- <sup>149</sup> The South African government, for example, published a report in 2004 which pointed out that the black population, which represents more than 60 per cent of the workforce, occupied 65 per cent of low to medium qualified jobs and 84 per cent of non-qualified jobs, but only 14 per cent of management jobs. Meanwhile, the white population, which represents 22 per cent of the workforce, occupies 77 per cent of upper management jobs and 2.7 per cent of non-qualified jobs.
- <sup>150</sup> Such initial growth in inequalities is partly related to saving and investment capacity (the basis of economic growth) which tends to be concentrated and therefore generates an increase in the income of the highest social strata.
- <sup>151</sup> Kuznet (1955)
- <sup>152</sup> Gallo (2003)
- <sup>153</sup> Adelman and Fuwa (1994)
- <sup>154</sup> Stewart, Brown, and Cobham (2009)
- <sup>155</sup> *Ibid.*
- <sup>156</sup> Jomo (2004)
- <sup>157</sup> *Ibid.*
- <sup>158</sup> Rasiah and Shari (2001)
- <sup>159</sup> *Ibid.*
- <sup>160</sup> Jomo *op cit*
- <sup>161</sup> Stewart, Brown and Cobham *op cit*
- <sup>162</sup> *Ibid.*
- <sup>163</sup> *Ibid.*
- <sup>164</sup> Jesudason (1989) and Heng (1997) quoted in Stewart, Brown, and Cobham *op cit*
- <sup>165</sup> Khoo (2006) quoted in Stewart, Brown, and Cobham *op cit*
- <sup>166</sup> Heng (1997) quoted in Stewart, Brown, and Cobham *op cit*
- <sup>167</sup> Khoo (2006) quoted in Stewart, Brown, and Cobham *op cit*
- <sup>168</sup> Jomo *op cit*
- <sup>169</sup> Bonner (2006)

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<sup>170</sup> International Trade Union Confederation (2007)

<sup>171</sup> Joshi and Ayee (2008)

<sup>172</sup> Terkper (1995) quoted in Joshi and Ayee *op cit*

<sup>173</sup> For example, in Argentina there is a tax on 'presumptive earning' levied on those low-scale activities that would have very high relative administrative costs if documents had to be presented.

<sup>174</sup> Joshi and Ayee *op cit*

<sup>175</sup> Joshi and Ayee *op cit*; Prichard (2009); Ghana National Chamber of Commerce and Industry (2008) quoted in Prichard (2009)

<sup>176</sup> Bonner (2006)

<sup>177</sup> Calculations using data cited by Prichard (2009)

<sup>178</sup> Oxfam (2009)

<sup>179</sup> Oxfam (2010)

<sup>180</sup> *Ibid.*

<sup>181</sup> One example of structural change has been the economic diversification experienced in South Africa over the last 20 years. In 1980, the mining sector represented 20 per cent of GDP, but, by 2007, it was barely 8 per cent. However, the relative importance of mining taxes in the total revenue collected between 2002 and 2007 was 2.4 per cent (a figure quite similar to the 2 per cent reached during the period 1990-1997).

<sup>182</sup> With subsequent amendments in framework regulation related to the fiscal system. See <http://www.lexadin.nl/wlg/legis/nofr/oeur/lxwezaf.htm> (accessed February 2011)

<sup>183</sup> Grote (2008)

<sup>184</sup> See Southern Africa Resource Watch (SARW), TWN Africa, Tax Justice Network Africa, ActionAid, and Christian Aid (2009)

<sup>185</sup> Counter-cyclical means moving in the opposite direction to the overall economic cycle: growing in strength when the economy is weakening and the other way around.

<sup>186</sup> Success of budget support in Rwanda quoted in Oxfam (2010), p 20.

<sup>187</sup> Oxfam (2010)

<sup>188</sup> Data on the shadow economy: Charmes (2000); Schneider and Enste (2000); Schneider and Buhn (2009).

Data on tax collection as a percentage of GDP:

African countries: OECD African Development Bank data (income from oil revenue is explicitly excluded from this data);

American countries: ECLAC;

Asian countries: World Bank.

Various sources were used, as the World Bank's revenue estimates tend to be overestimated, which is why alternative sources were used wherever possible.

<http://www.africaneconomicoutlook.org/en>

<http://data.worldbank.org/indicator/GC.TAX.TOTL.GD.ZS>

<http://websie.eclac.cl/infest/ajax/cepalstat.asp?carpeta=publicaciones>

Data on informal employment out of total non-agricultural employment: OECD (2009)

<sup>189</sup> Based on an econometric study with seven variables: the size of direct taxes, the size of the government (as a proxy of the ability to control taxes), fiscal liberty (an index that includes the maximum individual and corporate tax rates, as well as the tax to GDP ratio), the Ease of Doing Business Index, the unemployment rate, the per capita GDP, and the Index of Economic Freedom.

<sup>190</sup> Schneider and Buehn (2009).

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- <sup>191</sup> Under certain circumstances, the heavier the tax to GDP ratio is, the higher the incentive to dodge taxes.
- <sup>192</sup> The larger the percentage of informal employment, the better the theoretical prospect is of reducing it.
- <sup>193</sup> See Annex 1 for details about the data source.
- <sup>194</sup> McKinley and Kyrili (2009). The authors note that country performance could depend on the initial starting point. But they claim that it should be easier, for example, for a low-income country to raise its total revenue from 10 per cent of GDP to 15 per cent than to raise it from 15 per cent to 20 per cent. They also note that revenue levels under 15 per cent of GDP should be regarded as unacceptably low; and those countries having already reached 15 per cent should be encouraged to lift it to 20 per cent of GDP.
- <sup>195</sup> Quoted by Gupta and Tareq (2008), <http://www.imf.org/external/pubs/ft/fandd/2008/09/gupta.htm>
- <sup>196</sup> Intermón Oxfam (2010) quoting UN (2005) about the minimum funding requirements between 2006 and 2010, pag 160.
- <sup>197</sup> Guerena (2010)
- <sup>198</sup> For public education expenditure as a percentage of GDP, we used data from the last year for which data was available in the past five years.  
<http://data.worldbank.org/indicator/SE.XPD.TOTL.GD.ZS>
- <sup>199</sup> <http://data.worldbank.org/indicator/SH.XPD.PUBL/countries>
- <sup>200</sup> Oxfam (2009)
- <sup>201</sup> Sharife (2011)
- <sup>202</sup> Econometric study of seven variables: the size of direct taxation, the size of government (as a proxy for the ability to control taxation), fiscal freedom (an index that includes the highest individual and corporate tax rate and the tax to GDP ratio), business ease index, the unemployment rate, GDP per capita and the economic freedom index.
- <sup>203</sup> For example: Burundi, Senegal, Zambia.
- <sup>204</sup> For example: Nigeria, Thailand, Uruguay and Venezuela (Republic of)
- <sup>205</sup> <http://www.africaneconomicoutlook.org/en> (accessed February 2011)
- <sup>206</sup> <http://www.cepal.org/estadisticas/> (accessed February 2011)
- <sup>207</sup> <http://data.worldbank.org/indicator/GC.TAX.TOTL.GD.ZS> (accessed February 2011)
- <sup>208</sup> Schneider and Buehn (2009)
- <sup>209</sup> <http://www.africaneconomicoutlook.org/en> (accessed February 2011)
- <sup>210</sup> <http://www.cepal.org/estadisticas/> (accessed February 2011)
- <sup>211</sup> <http://data.worldbank.org/indicator/GC.TAX.TOTL.GD.ZS> (accessed February 2011)
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